Alternative Investment Fund Managers Directive ('AIFMD') Passes Important Milestone

On 17 May 2010, the Economic and Monetary Affairs Committee of the European Parliament ('ECON') adopted its position — that is, agreed upon a text — in respect of the AIFMD. On 18 May 2010, European finance ministers in the Economic and Financial Affairs Council ('Ecofin') agreed on a mandate for negotiations with the European Parliament on the basis of the text of 10 March 2010, prepared by the Spanish presidency.

Negotiations between the European Council, the European Parliament and the European Commission — a process known as 'trilogue' — will now begin, with the aim of securing agreement on a common text. If a common text is agreed upon, the AIFMD is likely to come into effect in the second half of 2012.

Differing Views Between Parliament and Commission

The most important areas where the Parliament and Commission take different views are the following.

Third Country Issues

This is perhaps the most critical aspect to the AIFMD, which can be divided into three separate parts.

EU-Based AIFM with Non-EU Fund

The Parliament text grants the EU AIFM a marketing 'passport' for the non-EU fund, enabling the fund to be marketed throughout the EU, if the country in which the fund is located satisfies the following conditions:

- it must have 'high enough' standards to combat money laundering and terrorist financing;
- it must grant reciprocal access to the marketing of EU funds on its territory;
- it must have agreements in place with the Member States where marketing is intended covering exchange of information relating to taxation and monitoring (the latter being between the supervisor of the fund and the Member State competent authority); and
- it must recognise and enforce judgments in the EU on issues connected to the AIFMD.

The fourth condition would have the effect of making third country supervisors (and third country courts) subordinate to decisions made in the EU. It is difficult to see any non-EU jurisdiction agreeing to this, and so the ability of an EU AIFM to exercise the passport would seem more a theoretical than an actual possibility.

If the country in which the fund is located satisfies the first two conditions, the EU AIFM can market the fund in any Member State that has entered into agreements with that country, which satisfies the third condition. This would effectively be a more restrictive version of the private placement regime that currently operates in the EU.

The Council text is much less restrictive. Provided that the EU AIFM complies with all the requirements of the AIFMD (except the majority of the depositary requirements), and there are 'appropriate' (the Commission is to specify what 'appropriate' means in this context) co-operation agreements in place between the AIFM's regulator and the supervisory authority of the non-EU fund, the non- EU fund can be marketed to professional investors in the territory of the AIFM. This means that in order to market the fund across the EU, 27 separate sets of agreements must be in place, which would be extremely cumbersome.

Non-EU AIFM with Non-EU Fund

The Parliament text provides that, in order to access the EU markets, non-EU AIFMs must agree to comply with the requirements of the AIFMD. In such cases, their supervisors must agree to act as agents of the European Securities and Markets Agency ('ESMA') in the supervision of the AIFMs. That may be problematic: whether the SEC, for instance, would be prepared to act as anyone's agent must be open to doubt. But even if these requirements are satisfied, a non-EU AIFM will only be able to market a non-EU fund in the EU if the country in which the fund is located satisfies the first three bullets set out above.

Under the less restrictive Council text, Member States can allow marketing to professional investors in their territories provided that the AIFM complies with certain limited provisions of the AIFMD, and there are 'appropriate' co-operation arrangements in place between the competent authorities of the Member State and the regulator of the non-EU AIFM.

EU Investors in Non-EU Fund

The Parliament text (but not the Council text) provides that if the jurisdiction in which the fund is located does not satisfy the first three bullets set out above, and certain other conditions are not met, EU investors cannot invest in the fund, even if no marketing has taken place in the EU. Such a restriction would have a significant impact on the ability of institutional investors in the EU to invest in alternative investment opportunities worldwide.

Private Equity

Unlike the Council text, the Parliament text exempts private equity AIFMs from certain provisions of the AIFMD, such as the capital requirements and the need to ensure that the fund has a depositary. However, while the Council text exempts investments by private equity funds in small and medium enterprises ('SMEs') from any disclosure requirements, and in any event requires disclosure only where the fund acquires more than 50% of the voting rights in the company, the Parliament text would trigger disclosure requirements when a far lower threshold (10%) is reached, and would reduce the scope of the exemption to companies with fewer than 50 employees. The Parliament appears to acknowledge that this discriminates unfairly against private equity, since it has called on the European Commission to review existing company law legislation so that companies owned by private equity are not at a disadvantage when compared to companies owned by other persons. But this is cold comfort, given the time that such an exercise is likely to take and the further delay before any change could take effect.

Depositaries

Both Council and Parliament texts expand the definition of depositary to include not just EU credit institutions (banks) but also MiFID investment firms. They also allow depositary functions to be delegated to third parties who are not depositaries. The Council text is, however, less restrictive as regards delegation of functions to third parties, allowing delegation outside the EU as well as sub-delegation. In contrast, the Parliament text does not allow sub-delegation, and allows delegation to an entity outside the

EU only if the third country in which the sub-depositary is located satisfies similar conditions to those set out above for the marketing of non-EU funds in the EU.

Areas of Agreement

In other important areas, the two texts are very similar, so the final text here is unlikely to change.

- **Delegation —** Both texts require AIFMs that intend to delegate functions to third parties to inform their regulator. The Parliament text provides that the regulator has one month to object. If the Parliament text prevails, this is likely to lead to regulators pre-approving any delegation by AIFMs, which would be inefficient and cumbersome. Both texts also provide that the liability of the AIFM is unaffected by any delegation. The more restrictive Parliament text — allowing delegation only to AIFMs managing funds of the same type — is likely to make global fund management significantly more difficult.
- **'Valuators' —** The original Commission proposal required the AIFM to ensure that each fund that it managed had an independent valuer (called a 'valuator'). Both texts now allow the AIFM to act as the 'valuator' of the fund provided that there are safeguards in place allowing the valuation function to be independent from the portfolio management function.
- **Capital Requirements** — Both texts align the capital required for AIFMs with that required for managers under the UCITS directive. This means minimum capital of €125,000 and a maximum of €10 million.
- **Leverage —** The Commission text required the Commission to set limits to the amount of leverage AIFM could employ. Both texts modify this so that the AIFMs set the leverage, leaving the regulators to impose limits if they think that the leverage amount poses a risk to financial stability.
- **Remuneration** — Both texts have remuneration provisions that were originally aimed at the banking sector. Under the Parliament text, these are mandatory; under the Council text, they are principles to be applied 'to the extent appropriate'.

Though it remains possible that some of the provisions of the AIFMD that firms find particularly difficult could be watered down in the 'trilogue' process, the reality is that any concessions at this stage are likely to be at the margin.

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