Asset Management

AIFMD News

A Directive in flux – the confusion persists

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Introduction

This note is to provide an update on the draft Alternative Investment Fund Managers Directive ("AIFMD") about the key areas of agreement and disagreement between the various parties debating the directive, and then recommends what managers can do to prepare for the time when a final draft emerges.

We consider the European Parliament's ECON (Committee on Economic and Monetary Affairs) Rapporteur's draft report, published on 25 November 2009, (the "Parliamentary Draft") and the supplemental re-draft of the Council's compromise position (the "Swedish Compromise"), the final version of which was issued on 15 December 2009.

We summarise

1. The proposed process and timetable from now;
2. The key points of difference and agreement between the original "Commission Draft", the Swedish Compromise and the Parliamentary Draft, and some outstanding issues;
3. Indications of the "direction of travel"; and
4. PricewaterhouseCoopers activity to help clients to prepare.

Background and timetable

Process to date:

The AIFMD is now firmly in the grip of the Brussels legislative process. The original draft produced by the European Commission ("the Commission") has been widely recognised as "not fit for purpose" by a broad range of affected constituencies. Acting through their respective committees with Commission support, legislators now have to engineer agreement between the European Parliament and Council of Ministers ('co-decision').

Some of the key ingredients for that agreement are now in place. The Swedish presidency's compromise positions show where member states have reached agreement and where they have not. The presidency issued its first compromise position in early November, releasing an amended version on 25th November and a final version on 15th December (the "Swedish Compromise"). Also on 15th December, the Swedish presidency issued its final progress report, handing over conduct of the AIFMD to the incoming Spanish Presidency. Working in parallel, the ECON Rapporteur responsible for guiding the directive through Parliament issued his draft report (the "Parliamentary Draft") on 25th November.

Timetable from here:

The timetable from this point is proposed, at least theoretically, to be rapid.

The Swedish Presidency was aiming to finalise the Council position before handing the Presidency over to the Spanish on 1 January 2010; and, ideally, wanted it finalised before Christmas. However, this effort has now come to an end, which means that the Spanish Presidency is now likely to play a much more decisive role in the finalisation of the Council's position. There are concerns that the Spanish presidency may not grant this the same priority as the Swedish did. The Swedish presidency's parting progress report – which identified four contentious areas of debate between member states where no consensus has been found – did highlight the need for the AIFM to continue to be a priority.

On the Parliamentary front, Jean-Paul Gauzès (EPP, France), the ECON Rapporteur, is expecting many amendments to be tabled in ECON prior to the 21st January deadline. Many members of ECON are expected to table amendments, as are members of the European Parliament's Legal Affairs Committee ('JURI'), which supports ECON on this dossier. The first exchange of views on the draft report in the ECON on 1st December provided some indications of likely amendments.

To inform its debate, the European Parliament has commissioned two impact assessments looking at the proposals. One of these, by Europe Economics, published on 8th December, anticipated that one-off compliance costs could total as much as €22bn, and the EU's annual GDP could decrease by as much as 0.2%.

Assuming that the Council and ECON can agree their respective drafts, "trialogues" between the Council, Parliament and the Commission will start in April, aiming to hammer out a compromise acceptable to all. (The ECON is due to approve its revised report at a meeting scheduled for 12th April.)

Lastly, a plenary session of the European Parliament is targeted for a vote on the final, agreed, text in July, 2010. After this there will be a two-year period during which the directive must be transposed into national law and level two regulations, and the directive's details will be fleshed out.

Comparing the drafts

The Swedish Compromise made considerable concessions to both industry and investor concerns, reducing reporting burdens and significantly reducing the potential impact on current industry business models. It tempered Commission requirements in areas such as the roles and responsibilities of depositories (at least partially) and valuers. It also relieved proposed restrictions on the ability of managers to delegate functions offshore, and substantially eliminated some of the "Fortress Europe" barriers limiting the ability of managers and funds established outside the EU to sell into the EU. The Swedish Compromise did, however, contain unexpected new provisions proposing substantial restrictions and transparency requirements on asset manager remuneration, in line with the Commission's April 2009 recommendations on compensation for banks.

The Parliamentary Draft, by contrast, is significantly less industry friendly, reflecting primarily political views rather than the wider views of industry or finance experts. The Rapporteur spoke to many industry representatives prior to drafting the report, suggesting that he and other members of the European Parliament may not fully agree with their views. However, voices were raised during the exchange of views in ECON on 1st December stressing the difference between the asset management industry and the banking industry – a distinction not fully reflected in the current draft report.

The Parliamentary Draft reasserts the Commission's position relating to the requirements for independent depositories and valuers (except, as regards valuers, for private equity firms); affirms the ban on delegation of investment management functions to firms outside the EU; removes the de-minimis thresholds which would have kept small funds outside the net of regulation, and reaffirms other controversial Commission proposals from the original draft. The only significant area where the Parliamentary Draft departs from the Commission's original proposal regards relationships with third countries, where it moves towards the Swedish Compromise's proposal.

The table below summarises the key areas of the AIFMD, outlining the different positions of the three drafts:

	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.	Bank and insurer exemptions disapplied except where managing own funds. Retains de minimis provisions. Makes clear managed accounts are excluded. Recognises concept of "self managed" AIFs.	Removes all de minimis provisions and the exclusion for the EU managers of non-EU funds.
Extension to offshore AIF managed by onshore AIFM	Yes, with 3 year window and, thereafter, by application of equivalence requirements for third countries.	No, selected provisions not applicable to offshore funds managed by onshore managers.	Yes, with no 3 year grace period.
Proportionality	No.	No.	Yes, to lighten burden on small funds. No detail of application.
Delegation	Detailed preconditions to delegation of functions. Bar against delegation of portfolio management to non-AIFMD authorised firms.	General delegation subject to notification rather than pre-clearance. Delegation of portfolio management to non-EU firms permitted, provided prior approval obtained or certain conditions regarding supervision met and there are agreements in place between relevant supervisors.	Same as Commission draft, but with added bars against delegating risk and liquidity management to non-AIFMD firms.
Leverage	Commission to have power to set pan-European limits on the amount of leverage that Funds and strategies may apply in advance.	Individual member state regulators can apply leverage caps if exceptional circumstances merit it, or to avoid pro-cyclical activity. Temporary basis only.	Funds will set and specify limits on leverage in advance subject to member state regulator rights of intervention. Commission has right of intervention in extremis .
Depositories	All AIF falling under directive to have external depositories. 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.	All EU based AIF must have a depositary. 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. Liability provisions ameliorated but not extinguished where delegation occurs (which is, itself, subject to rigorous limitations). Depositories to perform several administrative functions and police compliance of manager with fund documents and local law.	Permits non EU-domiciled AIFs to have a non-EU depository provided: (a) Tax Information Exchange Agreement (TIEA) in place, (b) the jurisdiction of establishment has equivalent regulation to the EU (as determined by the Commission) and there is a co-operation agreement in place between home member state of the AIFM and the depository's regulator.

	The Commission Draft	The Council Draft	The Parliamentary Draft
Valuers	Requires all funds to have independent valuers, performing valuations on each redemption or issue and otherwise at least annually.	Valuer does not need to be external, but function needs to be independent of portfolio management.	Removes requirement for independent valuers, but requires a valuer to be appointed, but makes depository and AIFM responsible for proper valuations. PE funds excluded.
Remuneration	Not mentioned.	All AIFM have remuneration policies that promote sound management and do not encourage excessive risk taking, but proportionate to the nature, scale and activities of the AIFM. Remuneration to be designed around a multi-year cycle. Mandatory deferral of a substantial proportion over a period appropriate to the life of the fund but this provision disapplied to pay sourced from fees earned by AIFM which cannot be clawed back by Fund. Detailed other provisions including disclosure requirements for carried interests and for significant AIFM to establish remuneration committees.	Substantially similar to Swedish Compromise. Pay policies must be consistent with G20 principles and be harmonised with bank requirements, and member state regulators to have powers of intervention if remuneration policies encourage excessive risk taking .
Position reporting	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	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.	Threshold defined by reference to EU "controlling influence", but scope of information to be reported remains substantial.
Marketing	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. Gives EU AIF a passport and non-EU AIF similar passport, provided equivalence tests met after a 3 year transition period.	Permits “reverse solicitation”. Has a wider definition of professional investors. Perpetuates private placement regime for non-EU funds but does not give them a passport.	Substantially adopts Council position.
Third-country provisions	1. Rules binding onshore managers in relation to funds they manage apply to both onshore and offshore funds (e.g. re depositories, valuers.) 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.	Selective rules disapplied in relation to offshore funds managed by onshore managers. An onshore manager can manage an offshore AIF if the AIF’s domicile’s legislation complies with IOSCO international standards on hedge fund oversight, and there is a co-operation agreement in place between the AIFM’s regulator and the Fund’s regulator. Offshore managers can market offshore funds into EU under existing private placement regimes but have no access to a passport.	1. Rules binding onshore managers in relation to funds they manage apply to both onshore and offshore funds (e.g. re depositories, valuers.). 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.

Core areas of agreement, contention and difficulty

The three drafts enable us to identify the areas of agreement and contention. They also show that there is still a lot of work where the Commission draft is inadequate or inappropriate, but where, as yet, neither the Swedish Compromise nor the Parliamentary Draft has made the necessary changes.

Areas of agreement:

- Onshore funds and managers will be regulated, and the breadth and length of regulation will catch many entities which are currently unregulated; managers will need to hold significant regulatory capital and to introduce internal systems and controls requirements similar to those imposed on MiFID investment firms, supplemented by liquidity management obligations;
- Systemically important information will need to be reported and gathered to allow member state regulators to make appropriate interventions;
- An onshore passport for qualifying funds and their managers has general support;
- It is likely that the final directive will contain provisions dealing with remuneration – no legislator has a particular interest in winding these back – but the precise extent of these will be vigorously debated, as indicated in the final Swedish progress report;
- Individual member state regulators will retain more authority to determine issues, whilst recognising the role of the new financial supervisory architecture being driven through the EU process;
- Depository duties and responsibilities will be increased – and hence operational costs for AIFM will increase.

Core areas of contention:

The final Swedish Presidency progress report identified four particular areas where no consensus had been achieved between delegations of member states. Their list comprised (a) depositories; (b) valuation; (c) remuneration; (d) third country issues and, in particular, the availability for a carve out from depository requirements for non-EU funds managed by EU AIFMs. As between Council and Parliament, other areas of contention are also visible.

- **Depositories:** The solution to the depositories issue is highly politically charged. Certain jurisdictions (particularly France), reacting inter alia to the Madoff fraud, are vehement supporters of the “strict liability” model. They wish to ascribe significant investor facing duties to depositories and to limit their ability to delegate functions or to contract out of liability. Other jurisdictions are more sensitive to industry concerns, recognising that a radical re-shaping of depository duties and functionality would have a very material effect on business models, operational costs and investors’ ability to access various overseas markets and hence that there is a substantial threat to risk adjusted returns. There are also clear dependent issues concerning what types of entity may actually function as a depository. The Commission and Parliament specify only EU credit institutions or MiFID authorised investment firms, while the Council would

allow other entities to perform these functions. Depository issues also form part of the debate over divisions of functions (see "service provider models", page 8).

- **Third countries:** The solution to the "third country" provisions is similarly highly charged, but with a different dynamic. Both Council and Parliament recognise the central importance to Europe of continued access to international flows of capital and to "best of breed" investment management, wherever located. They also recognise the virtual impossibility of enforcing a regime which requires overseas jurisdictions to have "equivalent" regulation of funds, managers and fiduciary service providers (although the Parliamentary Draft is looking for some "equivalence" around third country depositories in line with other EU legislation). Accordingly, both Council and Parliament seem to be advocating continuity of existing private placement regimes, as work on creating a harmonised EU regime for private placement has been abandoned. Yet the Commission is opposed to this solution, taking the view that it fundamentally weakens the "single market" aspects of the AIFMD, as well as leaving too large a loophole. As mentioned above, as far as the Council is concerned, the key area of difficulty is the extent to which non-EU AIF should have to comply with the depository requirements.
- **Delegation:** The widening of the AIFM's ability to delegate portfolio management functions to offshore entities set out in the Council Draft is crucial to many business models – particularly larger global operations with distributed manufacturing and distribution. The Parliamentary Draft's endorsement of the Commission's requirements in this area could be extremely problematic. Clear and sensible determination of delegation powers will also be key to resolving depository issues satisfactorily.
- **Controlling interest disclosures:** There is still significant difference of opinion about whether it is appropriate to impose disclosure obligations relating to interests in companies on a particular category of investors simply because those investors share common characteristics, and not to apply similar requirements to all investors. These provisions appear discriminatory and, particularly given the removal of de minimis provisions from the Parliamentary Draft, potentially unduly onerous – e.g. for small private equity funds.
- **Remuneration:** There is currently heated debate in Council about whether asset managers should be subject to the same controlled remuneration regime as bankers – or whether a model more adapted to the asset management industry should be adopted. There is a particular focus on carried interests.
- **Valuers:** At Council, there is continuing debate on the use and independence and liability of valuers.

Outstanding areas of difficulty:

- **Lack of differentiation:** The scope of the AIFMD remains problematic. Certain sectors (e.g. private equity) have been exempted from some provisions (e.g. valuation). Yet this partial measure fails to recognise the inappropriateness of the AIFMD applying to, for example, German Spezialfonds or UK-listed investment trusts. The Commission is sensitive to this issue and may suggest appropriate changes. As a subset of this issue, Parliament and the Commission have also recognised (but not yet fully acted on) the need to take into account entities already subject to EU regulation under other regimes.
- **Who the manager is:** Several open issues remain about precisely what functionality defines an AIFM, in order to ensure entities are clearly in or out of scope. For example, under what circumstances should investment advisors that provide advice to offshore managers or investment company boards, but do not have investment discretion count as managers? Who should be caught in a "multi-manager" or "platform" model? Clarification on precisely who is in and out, and precisely what specific functions within the EU will make an entity an AIFM subject to regulation, is crucial to operational planning.
- **Service provider models:** The various drafts fail to recognise the diverse ways in which the services that make funds of different sorts work are delivered. Administrators and fiduciary services providers are key across many sectors. Very few of them perform safe-keeping or custodial functions. Similarly, many custodians that currently provide safe keeping, nominee or prime brokerage functions do not provide the range of administrative services that both the Parliamentary Draft and the Swedish Compromise presuppose they should deliver. The combined effect of the liability provisions applicable to depositories, restrictions on delegation and ascription of specific functions to them, could reduce both the number of entities willing to assume the lead depository role and access to sub-custodians (for reasons of risk management concerns over due diligence). Such a shrinkage in the number of players would inevitably increase costs as well.
- **How proportionality will work:** The Parliamentary Draft removed de-minimis provisions, but the Rapporteur said that this would be compensated for by introducing a requirement for proportionality. How this will be made to work is unclear.
- **Where businesses should be located:** It is impossible at the moment to decide where to locate business operations because of uncertainties over which functions are in or out, and because the marketing and third-country provisions remain in flux. It is possible to imagine scenarios under which it would make sense to locate all functions offshore – to take advantage of lower service provider cost bases and greater access to global sub-custodial networks at sensible costs – and to rely on reverse solicitation or private placement regimes. Alternatively, one can equally envisage locating all functions onshore, in order to take advantage of a pan-European passport and the probable appetite of investors for the new safe, gold-standard AIFM product.
- **Tax:** The whole area of tax impacts remains uncertain but will clearly be business critical for many.

No clear direction

From the perspective of industry players, what firm conclusions can be drawn at this stage? The unsatisfactory answer is virtually none. With the publication of the Parliamentary Draft and having in hand the Swedish Compromise, the battle lines for the three interested constituencies have been drawn, but how the debate will advance is unclear.

The Council and Parliament will now discuss matters between them, with the Commission on the sidelines. But we are some way from a stable basis for these discussions. No single player has a veto or the ability to force its view on the others. Furthermore, the Parliamentary Draft is likely to be substantially amended in the coming months. The change of Presidency is not necessarily bad news. The Spanish have a reputation for efficiency and for endeavouring to find compromise, even if their public profile (as reported by the English-speaking press) is perceived as being less pro-business. However, the change of Commission, and the fact that the new Commission will not become operational until after it has been ratified by the European Parliament in January, means that the institutional infrastructure supporting these discussions remains in flux.

So the whole debate remains wide open and there is still a very large amount of work to be done, so that the Directive finally voted on does not have a disproportionate and restricting effect on the alternatives industry.

It is still relatively early in the process but the limited progress in Council discussions must mean there is a slight possibility that no agreement will be reached at all. There are two ways this could go. A decision could be taken to go to second reading under co-decision (the timetable currently is predicated on adoption of the directive in first reading). This would add some four to six months to the process overall, but would also leave more time for negotiation. However, if the European institutions push ahead with a first reading, or if they go to second reading and cannot find common ground even after the conciliation process, the whole process would go back to the drawing board.

A third possibility that has been discussed is that indecision might lead to the Spanish presidency promoting an emasculated directive – a pure “hedge fund directive” excluding private equity, real estate and other non-hedge funds – which all the parties might agree to. But this is a remote likelihood at this stage.

How can you prepare?

We cannot currently predict where AIFMD will come to land or how it will affect the key areas of organisational structure, relationships with depositories (or other outsourced service providers) and marketing of various products.

All industry participants, managers, service providers and investors are, unfortunately, in "planning limbo".

In order to be able to respond quickly when the final shape of the directive becomes clearer, asset managers need to start thinking about their detailed business map. They should identify who does what, who provides insourced or outsourced services (and where these services are provided from), who their investor bases are (EU, non-EU, professional or retail) and so on. We are developing tools to help asset managers do this. Custodians and other service providers also need to understand their own service delivery and to be starting to think how the Directive is likely to impact not only their asset manager clients but also them directly. All industry participants, to the extent they have not already done so, should be lobbying their MEPs and local regulators regarding the shape of the AIFMD. They should also ask their clients, investors and trade associations to do so.

It is very important for all industry players to continue to be aware of the changes that are working their way through the system and to get the mapping process started very soon. This will enable them to move swiftly when clarity starts to emerge, which we expect to be in March and early April 2010.

Across our network, members of the AIFMD core working group are analysing the potential impacts of the various drafts on our clients' businesses sector by sector. Furthermore, we are working with trade associations, large clients and others with a voice in the debate, as well as directly with the Commission, to try to influence the direction of travel for the benefit of managers.

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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