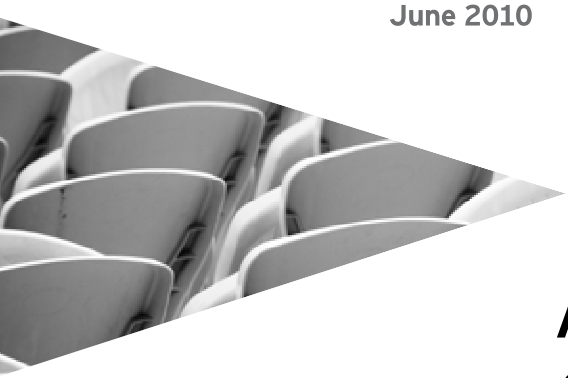
Alternative Asset Management
Quicknews: special edition
June 2010



# AIFM Directive

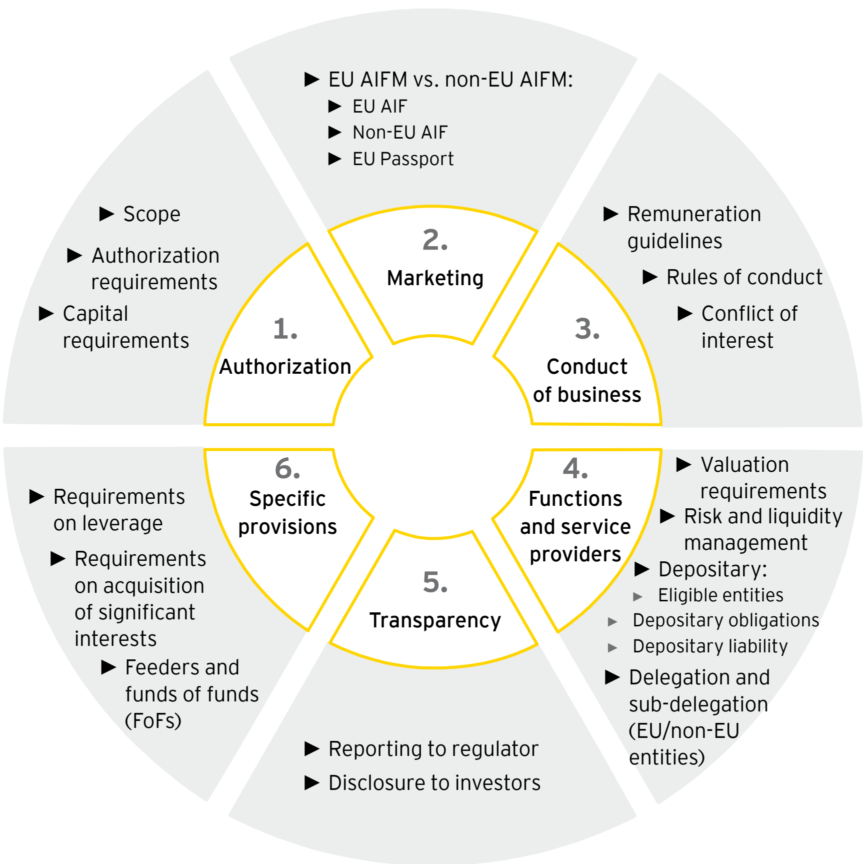
## Some light at the end of the tunnel?

On 18 May, the Council of the European Union agreed on its position on the Alternative Investment Fund Managers (AIFM) Directive, which will form the basis for negotiations with the European Parliament on the AIFM Directive. The previous day the Economic and Monetary Affairs Committee of the European Parliament adopted its position on the Directive. If agreement is reached between the European Parliament and the Council, the Directive could be finalized as early as July 2010.

### 1. Why the need for a Directive?

The European Commission proposed a new Directive introducing a harmonized EU regulatory and supervisory framework for AIFMs in April 2009. The stated aim of the Directive was to provide robust and harmonized regulatory standards for all AIFMs and enhance the transparency of the activities of AIFMs (and the funds they manage) toward investors and public authorities. In return for more regulation, the proposed Directive provided for the introduction of passports enabling AIFMs to offer their management services and market their Alternative Investment Funds (AIFs) throughout the EU.

The key provisions covered by the AIFM Directive are:




**In summary, the original aims of the AIFM Directive were to:**

- Ensure that all AIFMs are subject to appropriate authorization and registration requirements
- Provide a framework for the monitoring of macro-prudential risks
- Provide a framework for the monitoring and limitation of micro-prudential risks
- Provide a common approach for the protection of professional investors in AIFs
- Enhance public accountability of AIFMs holding controlling stakes in companies
- Develop the EU single market in AIFs
- Ensure that actions are proportionate to the risks posed and appropriately differentiated to take account of differences in AIFM business models

The AIFM Directive has been subject to fierce scrutiny, and many participants and commentators have said that the proposed provisions don't address the perceived risks, are unworkable in practice and weren't subject to appropriate consultation. As a result, the draft has passed through several presidencies at the European Commission. As the final Directive must be voted on by the European Parliament and the Council of the European Union, both institutions have been working to define their own positions on the Directive, redrafting the original legislative proposal from the European Commission. Given the controversial nature of the Directive, the European institutions have been subject to intense lobbying during this process.

The Swedish Presidency, for example, issued at least three compromise proposals during the second half of 2009 with a view to defining a common position within the Council. The subsequent Spanish Presidency issued seven compromise proposals, the latest one on 11 March 2010, which now forms the basis of its current negotiating position. The rapporteur of the Committee on Economic and Monetary Affairs (ECON) of the European Parliament, Mr Jean-Paul Gauzès, issued his draft report in November 2009. Following the submission of over 1,700 proposed amendments by members of the European Parliament, agreement was finally found within the ECON Committee in May.

## 2. The timetable going forward

It's taken over a year and the span of two European presidencies to achieve a number of compromises. The recently approved texts show important progress, regarding both the issue of proportionality and the need to adopt a differentiated approach in relation to funds managed by an AIFM, for example hedge funds or private equity funds. For the latter, if the EU Parliament text prevails, some funds would be more lightly regulated. However, there is still significant room for improvement and there are still a handful of important issues at stake. This leads some observers to comment that "there is little to celebrate and much to fear."

The next step in the legislative process is the so-called trilogue between the European Commission, the European Parliament and the Council of the European Union, the objective of which is to reach a compromise in July by vote in the European Parliament. Should the measures be voted through without dissent, the industry can expect to see transposition of the measures into legislation and implementation of the measures as early as the latter part of 2012.

## 3. Divergence approaches to be reconciled

While there is broad agreement between the Council and the Parliament on much of the Directive, there is a substantial divergence of views on a number of important provisions which will need to be reconciled if the potential for regulatory "gap" risk or regulatory arbitrage are to be avoided.

For small AIFMs, the Council provides for a very light regime and the potential for derogation, currently at the discretion of member states, while the European Parliament intends to apply more stringent conditions and requirements. The Parliament provides exemptions from some of the provisions of the Directive for the real estate and private equity AIF, including those on the depositary, and for entities with up to three investors.

The issue of depository responsibility and liability is a controversial measure which is likely to impose significant costs on the industry. The Parliament is more flexible on the tasks that a depositary may delegate, but the liability regime is onerous in both drafts. The two institutions differ in their approaches to whether and how limits on the leverage an AIF can assume will be set. There is also divergence regarding the acquisition of significant interest or controlling influence over non-listed companies and the required related disclosures.

## 4. The third country issue

Critically, the so-called "third country" issue or the terms on which funds and managers based in countries outside the EU (such as the US) can market to professional investors within Europe remains the main point of contention.

There are several critical issues at stake here. First, the potential restrictions imposed on investors' choice for EU companies. Second, the very real possibility for retaliatory actions by non-EU countries if the situation is left unmanaged. At least 68% of assets under management of global hedge funds were managed from the US in 2009, according to the London-based International Financial Services London (IFSL), and more than 32% of fund registrations took place in the US by Hedge Fund Research's Q2 2009 report.

The Parliament's text, as well as the Commission's original draft proposal, is oriented towards a pan-European solution to fund-raising and marketing, articulated around the idea of a passport for fund distribution across Europe. However, the institutions clearly differ. The Commission referred to the concept of

"equivalence", which is absent in the Parliament's draft. Under the Parliament's draft, non EU-based fund managers intending to market shares or units of an AIF to professional European investors would have to voluntarily subject themselves to the Directive's requirements. Furthermore, the competent authority of that non EU-based fund manager would have to sign an agreement with the European Securities and Markets Authority (ESMA) to act as ESMA's delegated agent in that manager's supervision. The non-EU manager would then be in a comparable situation to an EU-based manager benefiting from a passport for its EU-based funds.

However, for this manager to market its non-EU funds across Europe, there are five additional conditions with which firms will need to comply.[1] These provisions will also apply to non-EU funds that are managed by EU AIFM. As a consequence, EU-based professional investors would be prohibited from investing in non-EU funds if the third country does not meet all these criteria. This could be a challenge for EU hedge fund managers using non-EU fund domiciles, generally offshore centers, which do not necessarily meet the Parliament's criteria.

The Council's draft proposes a different approach. Following the pressure of certain EU governments, it restricts the benefits of the passport purely to EU-based managers willing to market EU-based funds across Europe. In this case, a Member State's national private placement regimes would apply. Non-EU AIFMs would be able to market non-EU funds in an EU Member State provided that there is sufficient information for investors and competent authorities, as well as appropriate cooperation arrangements between the competent authorities in the EU and those of the third-country manager. An EU AIFM would be allowed to market non-EU funds provided that they comply with some but not all the provisions of the Directive, and the Member State where marketing is intended allows distribution of AIFs.

## 5. Conclusion

The difference noted in approach between the texts drafted by the two co-legislative bodies suggests that there is still scope for further change between now and when the measures are expected to be announced in July 2010. The outcome of this debate is far reaching if, for instance, it erects (or is perceived to erect) additional barriers to US-based funds that could trigger retaliatory responses by the competent authorities in those third countries.

Indeed, given that over two-thirds of European VC funds and two-fifths of buy-out funds raise their money in the US, for instance, cutting them off would be a considerable backward step, not just for alternative asset managers but for the businesses they support.

All of this coincides with US Congress reaching agreement on May 20 to make Securities and Exchange Commission (SEC) registration mandatory for hedge funds, with all hedge-fund advisers over a certain size needing to register with the SEC, as per the Senate and House versions of the 2010 US Financial Reform Bill. It is now clear that many advisers to private funds that are not currently registered will need to register with the SEC as investment advisers. This move would give the SEC greater insight into hedge funds' trading positions and investment strategies, with US Congress also looking to empower the agency with regard to increased oversight of the industry's client base and counterparties.

The game is clearly far from over yet — much could still happen before a consolidated text is voted by the full EU Parliament in two months' time. We believe that the Directive will drive significant change in the structure of the alternative investment industry. Given the political momentum behind the Directive, it will become a reality sooner rather than later. Until now, our clients have been watching the progress of the Directive with interest but waiting until the text becomes clearer. However, alternative investment fund managers, their service providers and investors should start considering its effects, and how they will respond, now.

*1 These requirements concern the mutual exchange of information on tax matters and monitoring, evidence of robust standards to combat money laundering and terrorist financing, the granting of reciprocal access to marketing of EU funds on its territory, and recognition/enforcement of judgments given in the EU on issues related to the AIFM Directive.*

*The five conditions listed in article 35 concern the fact that an AIFM may only market shares/units of a non-EU AIF to EU professional investors if:*

1. *There is a co-operation agreement between the Member State and the supervisor of AIF (systemic risk)*
2. *The standards to prevent money laundering and terrorist financing meet Financial Action Task Force (FATF) requirements*
3. *There is an OECD Model tax convention for exchange of tax information between the third country, Member State where it applies for authorization and any other Member State in which shares are marketed*
4. *The third country grants EU AIFM comparable market access*
5. *There is recognition and enforcement of judgments rendered in the EU*

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