

AIFM Directive Update

Introduction

Mayer Brown has previously provided an assessment of the Council of the European Union's ("Council") draft compromise proposal (the "**Compromise Proposal**") on the Directive on Alternative Investment Fund Managers (the "**Directive**") published on 12 November 2009.¹

As explained in that Alert, industry participants are currently lobbying in relation to two "live" drafts of the Directive, the Council draft and the European Parliament's draft. Following the publication on 23 November 2009 of a draft report by Jean-Paul Gauzès, the Rapporteur responsible for steering the Directive through the European Parliament² (the "**Gauzès Report**") and a revised version of the Council's Compromise Proposal on 15 December 2009³ (the "**Revised Compromise Proposal**") the respective positions of the key institutions is now clearer. The Council recently published an issues note⁴ (the "**Issues Note**") comparing and contrasting the current positions of the Council and European Parliament and inviting comments from national delegations. This Client Alert takes this pertinent opportunity to perform the same comparative task in the context of the key issues for the industry.

Application

The Revised Compromise Proposal has not amended the application of the Directive following the changes made in the Compromise Proposal. The Directive would apply to all alternative investment fund managers ("**AIFM**") established in a Member State of the European Union ("**EU**") which manage one or more alternative investment funds ("**AIF**") which are non-UCITS regardless of whether the AIF itself is established inside or outside of the EU. The Revised Compromise Proposal retains the exemption for AIFM managing assets of less than €100 million or €500 million where redemptions in the AIF are prohibited for the first five years and there is no leverage.

The Gauzès Report proposes to change the application of the Directive by removing the minimum threshold exemptions. AIFM managing assets of any value will fall within the scope of the Directive, irrespective of any prohibition on redemptions and/or the absence of leverage. Accordingly, the Directive would extend to the smallest AIF. This change is apparently motivated by a concern that exemptions should be kept to a minimum and that the proportionality principle should instead be applied throughout the Directive. Venture capital funds are likely to vigorously contest this change.

Conditions for granting approval

The Revised Compromise Proposal has not made any changes to the fundamental principles in this area. AIFM will be required to meet minimum capital requirements and those involved in management of AIFM must satisfy suitability criteria. Unfortunately, no clarity has been provided on the ability of regulatory authorities to refuse authorisation in circumstances where such authorities are concerned that their supervisory functions would be prejudiced by an AIFM having close links with other natural or legal persons. One change with potentially far reaching implications is that the Committee of European Securities Regulators ("**CESR**") has been given responsibility for drawing up guidelines on classifying different AIF investment strategies. These classifications will be significant items of level two legislation because they can be expected to be built into numerous rules adopted by regulators, as well as contracts used by the private investment community.

The Gauzès Report proposes a number of mostly technical amendments to the conditions for granting approval. The most important of these changes include: (i) anti-avoidance amendments to capture master feeder structures and funds of funds; (ii) a three-month window for regulatory authorities to grant or refuse an application under the Directive (as

compared to two months in the European Commission’s (the “**Commission**”) proposal and six months in the Revised Compromise Proposal); and (iii) a restriction such that an AIF may only be managed by one AIFM.

Capital maintenance

The Revised Compromise Proposal has not amended the position on capital requirements set out in the Compromise Proposal. Under current proposals, AIFM will be required to maintain capital of at least €125,000 and, where the value of AIF-managed assets exceeds €250 million, the AIFM would have to maintain an additional 0.02% of the amount by which the AIF assets exceed €250 million. However, capital requirements are to be capped at €10 million. The Directive would allow for Member States to reduce capital requirements for AIFM managing in excess of €250 million by 50% of the supplemental amount, if such AIFM benefit from appropriate parent company or similar guarantees.

The Gauzès Report has proposed the same €10 million cap and scope for reductions in the case of the AIFM benefiting from guarantees. The consensus on this issue suggests that this model is likely to be one finally adopted. However, the Gauzès Report additionally requires that AIFM invest own funds in liquid assets or that they are readily convertible to cash in the short-term and that AIFM maintain professional indemnity insurance.

Remuneration policies

The Revised Compromise Proposal has not introduced any substantial amendments to the remuneration provisions in the Compromise Proposal. Notwithstanding industry resistance to such provisions on the basis that AIFM performance fees are already aligned with investor interests, the Gauzès Report follows broadly comparable principles. It seems likely therefore that remuneration policies in one form or another will remain.

Liquidity management

The Revised Compromise Proposal has widened the application of those AIF required to adhere to liquidity requirements such that only “unleveraged closed-ended AIF” will be exempt. Thus, not all closed-ended AIF will be exempt as under the Compromise Proposal. This extension is not unexpected on the basis that leveraged funds require a degree of liquidity to service

their debt. Therefore, as long as the liquidity rules are proportionate to the requirements of a particular AIF, it is also sensible. It remains to be seen whether the level two provisions will adopt a truly proportionate approach to liquidity. The Gauzès Report has not proposed any amendments to the Commission’s proposals in this area.

Valuation

The Revised Compromise Proposal makes only one amendment of note to the Compromise Proposal by specifying that provisions setting out the “appropriate level of functional independence of the valuation function” will be implemented by the Commission in secondary legislation.

The Gauzès Report has made some helpful, and some not so helpful amendments in this area. It has agreed with the Council and eliminated the need for an “independent valuator” and accepted that valuation may be an “independent function”. However, the Gauzès Report has materially changed the definition of “valuator” such that valuers must be “legal persons authorised and supervised by a competent authority”. There is no guidance as to what this might mean in practice. The Gauzès Report has also helpfully incorporated a general exemption from valuation requirements for private equity funds. This is logical on the basis that regular valuations are inappropriate given private equity funds’ business model and the expectations of their investors. However, in an entirely new amendment, an AIFM and its depositary would be jointly responsible for the proper valuation of AIF assets as well as for the calculation of the net asset value of the AIF. This would be a non-delegable joint responsibility. This extension of a depositary’s obligations and potential liability is likely to be highly problematic. At best, depositary fees can be expected to increase disproportionately to any enhanced protection for investors resulting from joint liability.

Depositary

The Revised Compromise Proposal has done little to change the fact that the proposals relating to depositaries remain commercially and practically problematic in a number of areas. The Gauzès Report also contains most of the problematic provisions and imposes even greater requirements in a number of areas.

Both the Revised Compromise Proposal and the Gauzès Report state that for each managed AIF, an AIFM

would be required to ensure that a “depository” holds all financial instruments that can be kept, and that are subject to regular trading, in segregated accounts opened or held in the name of one or more AIF. As previously explained, such a requirement runs contrary to current market practice for custodians (in those instances where global custodian banks rather than prime brokers etc., are currently used) who hold assets in their nominee name or the name of a sub-custodian nominee company for the benefit of the relevant AIF.

Furthermore, both the Revised Compromise Proposal and the Gauzès Report contain provisions such that the depository would be required to ensure that no AIFM instructions conflict with applicable national law and relevant AIF rules or instruments of incorporation. Each text also makes depositaries responsible for ensuring that the value of shares in AIF are calculated in accordance with applicable national law and the AIF rules or instruments of incorporation, consideration is remitted in usual time limits, and an AIF’s income is applied in accordance with applicable national laws and the AIF rules. These rules essentially make depositaries the *de facto* regulators of AIFM in these specified areas. The literal interpretation of these provisions is such that a depository would be required to confirm prior to settling any investment that the trade is in accordance with applicable laws and the AIF’s offering documents and constitution. For AIF which regularly trade, such an approval process would be commercially unworkable. Furthermore, depositaries may not have the systems or procedures in place, particularly at sub-custodian level, to fulfil this function and may not be able to put in place such a function.

The Gauzès Report and the Revised Compromise Proposal allow depositaries to delegate certain functions to sub-custodians. However, both texts essentially require that depositaries retain liability for any financial loss arising from such delegation whether or not they have exercised due skill, care and diligence. The Revised Compromise Proposal would allow a “depository” (in relation to loss of securities only) to discharge itself of the above strict liability on a contractual basis (i.e. not as against third parties), provided it could prove that it had exercised due skill, care and diligence and it had disclosed this contractual discharge to investors. The Gauzès Report provides a still more limited exception. In circumstances where a depository is legally prevented from performing its functions (i.e. it is forced to delegate obligations), the depository may shift its liability by means of a contract between AIFM, the depository, the third party and the investor.

As currently drafted, both texts run contrary to the market practice where custodians “appoint” sub-custodians to perform functions in jurisdictions where they do not themselves operate (they may be legally entitled to operate in these jurisdictions but choose not to for commercial reasons) rather than “delegate” functions to them (i.e. they do not accept a primary obligation for functions that they do not themselves perform).

The Gauzès Report has also proposed that where an AIF is managed by an authorised AIFM domiciled in a Member State of the EU, the depository will be required to have its registered office in the Member State where the AIF is domiciled. This change is of particular concern when read in conjunction with the proposal that the depository of an AIF domiciled in a third country will be required to have its registered office in a Member State of the EU unless, among other things, the AIF third country is the subject of a decision stating that depositaries domiciled in that third country are subject to effective regulation (i.e. an equivalency ruling). For third country depositaries looking to do business in the EU, and for EU depositaries looking to operate across the Community, these provisions will be highly problematic. Indeed, these measures appear to run contrary to the fundamental principles of the EU and are likely to have a negative impact on competition and consumer choice. Furthermore, they increase the likelihood that risks will be consolidated in those Member States where most AIF are domiciled.

Influence in non-listed companies

The obligations imposed upon AIFM managing AIF that acquire interests in non-listed companies have more limited application than the Compromise Proposal. Under the Revised Compromise Proposal, the provisions apply only to interests of 50% or more in a non-listed company that is not categorised as a small or medium-sized company. The Gauzès Report has used the language of “controlling influence” instead of providing an empirical measure for control. There is little doubt that AIFM in the private equity industry will continue to lobby against these obligations on the basis that they will result in such AIFM suffering a competitive disadvantage as against other potential purchaser of non-listed companies.

Leverage limits

The Revised Compromise Proposal maintains the reactive, disclosure based approach to leverage limits found in the Compromise Proposal. National regulatory authorities are afforded the power to monitor leverage limits through AIFM disclosures and, in the event that the stability and integrity of the financial system is threatened, they may impose leverage limits.

The Gauzès Report requires AIFM to define leverage limits in advance for every AIF they manage. As such, a proactive system of self-regulation is created, because presumably AIFM will be practically, if not legally, bound by the limits they impose upon themselves. Furthermore, rather than following the Council's approach and simply deleting the provisions under which the Commission is entitled to set leverage limits, it provides that the Commission may set limits, following advice from the ESRB, in the event that the European Securities and Markets Authority ("ESMA") (the body intended to supersede CESR) determines that the leverage employed by an AIFM threatens financial stability. Such measures would seem to be logical ways of dealing with the AIF-specific and macro-economic risks associated with borrowing.

Marketing and management of AIF in third countries

The Directive creates a single passport for EU based AIFM to sell onshore AIF to professional investors across the EU. However, the position in relation to AIF in third countries remains unclear.

The Revised Compromise Proposal provides for individual Member States to allow AIFM to market and manage AIF established outside the EU to and for professional investors. This provides scope for private placement regimes to operate outside of the Directive subject to the discretion of national governments. The Council has retained the requirement that AIFM may only manage a third country AIF if: (i) the third country has "relevant legislation" that is "in line with" standards set by international organisations such as IOSCO, or the AIFM can otherwise show that the AIF complies with those standards; and (ii) there is a cooperation agreement between the AIFM's regulator and the third country's regulator.

The Gauzès Report also provides that a Member State may allow AIFM to market third country AIF, but only if either: (i) the AIFM is domiciled in the EU; or (ii) there are information-sharing

and cooperation agreements, in line with relevant international standards, in place between the third country and the Member State, between the AIFM and its regulator, and between the AIFM's regulator and ESMA. A complimentary condition in the Gauzès Report is that in order for EU investors to invest in a third country AIF, the AIFM must be domiciled in the EU, or an information-sharing cooperation agreement must be in place between the third country and the Member State. Further, guidance will be required before either of these provisions can be reasonably interpreted.

In relation to management, the Gauzès Report requires that AIFM are always in a position to satisfy the requirements of the Directive. It is also worth noting that the Gauzès Report's provisions on depositaries and valuers in third countries will create significant hurdles for the managers of non-EU AIF.

The marketing provisions in both the Revised Compromise Proposal and the Gauzès Report include anti-avoidance measures to ensure that feeder AIF established in the EU cannot invest in master AIF outside of the EU that are not authorised under the Directive.

Market access for third country AIFM

The Commission's initial proposal was heavily criticised because the equivalency standards it imposed on non-EU jurisdictions would have prevented many third country domiciled AIFM from accessing European markets, including AIFM in the United States. Despite improvements in this area, it remains unclear exactly how third country domiciled AIFM will gain access to European investors.

The Issues Note has clarified that in the Council's view the Directive does not apply to AIFM established outside the EU whether or not the AIF is marketed actively or passively. It therefore seems that that third country domiciled AIFM will be able to continue to market funds via private placements, outside the scope of the Directive, on a Member State by Member State basis (as is currently the case). However, this is not expressly stated in the Revised Compromise Proposal.

As set out above, the Gauzès Report provides that where an AIFM is domiciled outside the EU, a series of information sharing agreements must be in place, both to market AIF within EU Member States, and to enable European investors to invest in their funds. Without further clarity as to the form and content of these agreements, it will be impossible to assess their impact on the industry.

Conclusion

The Compromise Proposal addressed some of the concerns relating to leverage limits, liquidity, valuation, third country AIF and marketing. However, industry resistance and lobbying is likely to continue to gather pace as a result of the Revised Compromise Proposal failing to address reasonable commercial concerns in relation to depositaries, remuneration and influence in non-listed companies.

The Gauzès Report has taken a more cautious approach to amendments and recommended tighter rules in important areas. In particular, Gauzès has taken a conservative approach in relation to leverage limits, valuation, and AIF and AIFM domiciled in third countries. Gauzès also seeks to limit the scope of exemptions within the Directive and extend certain disclosure requirements. Of particular concern, the Gauzès Report makes the depositary provisions even more unworkable. It fails to take into consideration the practicalities of the industry and, at worst, could consolidate risk, stifle competition and significantly reduce investor choice and investor returns.

When viewed together, the Revised Compromise Proposal and the Gauzès Report warrant a mixed reaction. The initial Commission proposal has been improved. However, the picture is not a consistent one and the gap between the institutions is greater than the Issues Note suggests. In some areas, the Council and European Parliament have moved to comparatively similar and potentially encouraging positions, e.g. liquidity requirements and marketing. In other key areas, and in the detail of many provisions, important differences remain between the institutions and these may be to the advantage of the AIFM industry as it seeks to engineer optimal outcomes in the key areas. In other fundamental aspects of the Directive (notably, the provisions relating to depositaries and remuneration), the stars are aligning in such a way that significant resources will need to be marshalled if undesirable outcomes are to be avoided. The ambition is to agree a final text in the May 2010 trilogies to be held between the Council, European Parliament and Commission. Accordingly, much ground needs covered if the Directive is to be transformed into a workable and acceptable regime by the time of its adoption.

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Footnotes

- 1 http://www.mayerbrown.com/public_docs/0386fin-Draft-Compromise_alert.pdf
- 2 http://www.europarl.europa.eu/meetdocs/2009_2014/documents/econ/dv/796/796533/796533xm.pdf
- 3 <http://register.consilium.europa.eu/pdf/en/09/st17/st17330.en09.pdf>
- 4 <http://register.consilium.europa.eu/pdf/en/10/st05/st05164.en10.pdf>

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