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## The Alternative Investment Fund Managers Directive: What Can We Expect?

For private equity and venture capital firms, the regulatory topic of 2010 is the proposed Alternative Investment Fund Managers Directive (the Directive). The Directive would introduce a compulsory regulatory and supervisory regime for managers of alternative investment funds (Managers) which are aimed at EU investors. Assuming it becomes law, the Directive will have a far-ranging impact on the investment industry, including hedge funds and private equity funds.



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### Legislative Progress

In April 2009, the European Commission published its proposal for the Directive. To become law, the Directive must be adopted by the Council of the European Union and the European Parliament. There are currently two competing drafts of the Directive; one agreed by the Economic and Monetary Affairs Committee of the Parliament on 17 May 2010 (the Parliament Draft) and the other by the finance ministers from each Member State on 18 May 2010 (the Council Draft) (collectively referred to as the Drafts). The Drafts now have to be reconciled so that a final version is agreed on for voting and adoption. If adopted during July 2010 as proposed, the Directive will not become law in EU Member States until July 2012.

### The Key Issues

This article summarises the main issues surrounding the Directive and discusses key differences between the Drafts.

**SCOPE:** The scope of the Directive is very broad. A fund may be open or closed-ended, constituted as a company, a trust, under a contract, a statute, or in any other legal form. There are only a limited number of funds, such as smaller funds, that may be excluded from the Directive and its provisions. The Parliament Draft makes certain specific provision for private equity funds and provides that certain provisions, such as the appointment of a depository and the capital requirements, will not apply to Managers of such funds.

**AUTHORISATION:** The Directive would require Managers established in an EU Member State to be authorised in the Member State in which

they are based, regardless of whether the fund(s) are established in the EU or outside the EU. As part of the authorisation process, Managers must provide their Home State regulator with comprehensive information including information on directors and shareholders, organisational structure, investment strategies and risk profiles. Both Drafts require a number of pre-conditions to be fulfilled before authorisation will be granted, including minimum capitalisation requirements. A Manager authorised in one Member State would be able to provide management services to a fund established in another Member State (the Directive would allow them to “passport” their services between Member States).

**REPORTING:** There are substantial ongoing reporting obligations to Home State regulators. Managers will have to disclose wide ranging details about their businesses, potentially including: market, liquidity and counterparty risks, principal exposures, leverage levels, stress test results, short selling arrangements and investor and management fees.

**DISCLOSURE:** Both Drafts make provision for disclosure to investors, both prior to their investment, and at regular intervals subsequently. Most of the information required is similar in both Drafts and includes information relating to the investment strategy and objectives of the fund, a description of all associated risks, the details of custody arrangements, applicable investment restrictions, valuation procedures, and the liquidity risk management arrangements.

**DEPOSITARIES:** Under both Drafts, Managers must appoint an independent depository to take custody of the fund’s investor payments

and financial instruments. The depositary must be established in the home Member State of the fund. The depositary is required to hold financial instruments in segregated accounts, verify title to and ensure investments are made in accordance with applicable laws of the Member State. The depositary is allowed to delegate its functions on certain conditions, although the Parliament Draft specifies that depositaries cannot delegate functions of selection, monitoring and oversight.

**REMUNERATION:** The issue of remuneration for staff has, since the financial crisis, become a contentious topic among Member States. As a consequence, both Drafts include wide-ranging provisions dealing with staff remuneration. Managers must have remuneration policies for staff (including senior management) which promote effective risk management and discourage risk taking that is inconsistent with the fund's risk profile. Both Drafts also include detailed lists of remuneration principles which must be considered in formulating such policies including a number of particularly onerous requirements on guaranteed bonuses, risk adjustments to performance related payments and the deferral of a substantial proportion of bonuses over an appropriate period for the type of fund in question.

**LEVERAGE:** The Drafts differ in their treatment of leverage limits. The Council Draft allows Member States to impose leverage limits. Leverage limits would only be imposed when this was necessary

to ensure the stability and integrity of the financial system and to limit the extent to which leverage causes systemic risk in the economy. In contrast, the Parliament Draft would require Managers to set their own leverage limits, taking into account the type of fund, the source of leverage and counter-party exposure. These limits would be reviewed by the Manager's Home State regulator. The Parliament Draft also makes specific reference to the European Securities and Markets Authority (ESMA) (which is intended to be in operation next year) which would have substantial powers to influence the amount of leverage employed by funds located in the Member States.

**COUNTRIES OUTSIDE THE EU:** The Drafts contain provisions relating to the terms on which Managers and funds based in countries outside the EU can market to professional investors inside the EU. Under the Parliament Draft, a non-EU Manager seeking to manage funds in the EU would be required to comply with the Directive's requirements. In addition, the regulatory authority of the non-EU country would have to sign an agreement with the ESMA to act as a delegated agent in the supervision of that Manager. Non-EU funds would be allowed to be marketed in the EU provided that their home country had adequate measures to tackle issues such as money laundering and terrorist financing, and also allowed EU funds reciprocal market access into their territory. Agreements must also be in place with each Member State in relation to the sharing of tax information.

The Council Draft provides that a Member State may allow a Manager established in a non-EU country to market its fund to professional investors in that Member State if the fund complies with substantial requirements (including disclosure to investors, reporting to authorities, annual reports and leverage) and if appropriate cooperation arrangements for the purpose of systemic risk oversight are in place between the regulatory authorities of the Member State where the fund is marketed and the Manager's regulatory authorities to ensure the sharing of information.

### Conclusion

There has been substantial concern and debate about the Directive, both within and outside the EU. Most have accepted that the Directive is likely to become a reality in the near future. However, significant work remains to be done before an agreement is reached on the Directive's final form. It is essential that, during the negotiations, further consideration is given to legitimate investor demands for a variety of investment managers, business models and risk exposures to be considered, both to avoid the dilution of investment choice and to ensure that the competitiveness of the EU private equity and venture capital industry is not compromised. It is also important that consideration is given to global players, such as the US, and the potential damage that the provisions on countries outside the EU will have on the private equity and venture capital industry at a global level.

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