

Draft Directive  
on Alternative  
Investment  
Fund Managers

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# Draft Directive on Alternative Investment Fund Managers

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## DRAFT DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS






### **Introduction – the new regulatory landscape for non-UCITS within the European Community**

On 30<sup>th</sup> April, 2009, the European Commission published a proposal for a Directive of the European Parliament and Council Directive (the “Directive”) to establish a harmonised EU framework for the authorisation and operation of the managers of non-UCITS collective investment undertakings (“AIF”) (“managers of alternative investment schemes” or “AIFM”) regardless of the domicile of the AIF, and for the marketing of such AIF within the Community.

The draft legislation is currently with the European Parliament and European Council. Subject to political agreement on the text by the end of this year or start of next, the Directive could be set for implementation in Member States as early as 2011 or 2012 (Member States are usually given between 18 months and 3 years from the date of the adoption of a Directive to transpose a Directive into their national laws). The provisions in the Directive regarding the treatment of third countries will only become applicable after a period of transition of three years following the adoption of the Directive.

### **Purpose of the Directive**

The purpose of the Directive according to the Commission’s accompanying Impact Assessment document is to;

-  Ensure that all AIFM are subject to appropriate authorization and registration requirements;
-  Provide a framework for the proper monitoring of the macro and micro prudential risks that the activities of AIFM pose;
-  provide a coordinated approach to the oversight of risk management processes, internal governance and transparency of AIFM;
-  Develop a single market in AIF and provide a common approach to the protection of professional investors (as defined in Annex II of Directive 2004/39/EC (MiFID)) in AIF; and
-  Enhance public accountability of AIFM holding controlling stakes in companies.

The Directive as proposed will radically alter the manner in which AIFM operate in Europe and will impose significant requirements in terms of their capital, internal organisation, the

manner in which they organize AIF, their responsibility for the management of the AIF, the conditions under which they can delegate their activities, and it includes significant requirements as regards safe-keeping of AIF assets, AIF leverage and AIFM's obligation to disclose information regarding the AIF that they manage to investors and Member State regulators. It impacts not only on hedge funds and private equity funds, which it clearly targeted, but all non-UCITS established in or marketed in the European Community, including real estate funds, infrastructure funds and even regulated non-European retail mutual funds. In effect, within three years of adoption, it will be very difficult to sell non-European funds in Europe, particularly unregulated funds, and the Directive will make it difficult and more expensive for non-European managers, administrators and depositaries to service non-UCITS that are sold into Europe. This Directive is in part a measured attack on the Cayman Islands and other unregulated offshore fund centres.

### **Background to the proposed Directive**

For years the European Commission has been under political pressure to regulate the activities of hedge funds and private equity funds, in particular in relation to short selling and leveraged investment in EU companies. Parliament had previously resolved in 2004, 2006 and twice in 2007, that some form of EU wide regulation should be introduced in the area of hedge funds and private equity funds. The Commission has sole authority to initiate legislation in areas of European law where the "co-decision" procedure applies such as the area of financial services (Parliament and Council adopt legislation together in these areas) and rejected all previous requests on the basis that there was existing legislation in the particular area or more generally that the Commission saw no need to specifically regulate hedge funds or private equity funds.

The context in which these demands were being made dramatically changed over the past twelve months following the global credit crisis, and when the G20 meeting of April, 2009 reflected a global consensus for a tighter regulation of the alternative investment fund sector, regulation in Europe was made inevitable. The immediate impetus for the Directive was the adoption by the European Parliament in September 2008 of two own initiative reports with recommendations to the Commission on hedge funds and private equity (Report of the European Parliament (A6-0338/2008) ['Rasmussen' report] and with recommendations to the Commission on transparency of institutional investors (European Parliament report A6-0296-2008) ['Lehne' report]) which had been tabled for consideration in plenary by, respectively, Poul Nyrup Rasmussen, the Danish MEP and former Danish Prime Minister (Party of European Socialists (PES), the second largest political party in Europe) on behalf of the European Parliament's Economic and Monetary Affairs Committee (ECON) and by Klaus Heiner Lehne, the German MEP and member of Merkel's Christian Democrats (Group of the European People's Party and European Democrats (EPP-ED), the largest political party in Europe) on behalf of the Parliament's Legal Affairs Committee. The two Reports were presented under Rule 39 of the European Parliament's Rules of Procedure whereby the

Parliament can request that the Commission draw up legislation (reflecting Article 192 of the Treaty).

Given the legislative process which the draft Directive must now go through, it is significant to note that the Reports themselves passed through their respective committees and the Parliament with almost unanimous support. Having said that, the final text of the Rasmussen report as adopted by the European Parliament was substantially amended from the one first proposed by Rasmussen in March 2008, notably as regards Rasmussen's suggestion that an EU-level supervisory body be established, a European system of registration and approval for asset management and fund management companies be put in place and a debt limit for capital investment funds be introduced. Rasmussen referred to the text of the Report that was adopted by the Parliament as a compromise between PES, the Group of the Alliance of Liberals and Democrats for Europe (ALDE) and EPP-ED. The poor performance of the socialist grouping in the June 2009 European elections and the strong showing of EPP-ED may prove to be significant in the passage of the Directive over the coming months.

#### **Scope of the Directive – the requirement for AIFM to seek authorisation**

The Directive applies to any person established in the European Community, whose regular business is to manage one or more AIF and which provides management services to one or more AIF irrespective of where the AIF is domiciled and whether the manager is appointed directly or by delegation.

The definition of AIF will extend to any non-UCITS irrespective of domicile, legal form, liquidity or investment strategy. The definition will exclude single investor mandates such as managed accounts and other non-collective investment undertaking structures.

“Management services” are “the activities of managing and administering one or more AIF on behalf of one or more investors”.

The Directive (Section 1 of Article 4) requires that;

*“Member States will prohibit any AIFM covered by the Directive from providing management services to any AIF or from marketing shares or units in such AIF without prior authorization; and that*

*Entities that are neither authorized in accordance with the Directive nor, in the case of AIFM not covered by the Directive, in accordance with the national law of a Member State, shall not be allowed to provide management services to AIF or market units or shares thereof within the Community.”*

There are a number of entities who might otherwise be subject to the Directive but are exempt under Article 2:

- (i) managers which either directly or indirectly through an entity in which the manager is a substantial direct or indirect investor or with which the manager shares common management or control, have assets under management, including assets obtained through leverage, of 100 million Euro, or 500 million Euro when the funds are unleveraged with no redemption rights exercisable during a period of 5 years following the date of constitution of the relevant fund;
- (ii) managers established in the Community who do not manage AIF that are domiciled in the Community and do not market [any] AIF in the Community;
- (iii) UCITS or their management companies;
- (iv) credit institutions covered by Directive 2006/48/EC;
- (v) Occupational pension fund managers;
- (vi) Life and non-life insurance companies and re-insurance companies covered by Directive 73/239/EEC, Directive 2002/83/EC and Directive 2005/68/EC respectively; and
- (vii) Supranational institutions, such as the World Bank, the IMF, the ECB, the EIB and the EIF.

Managers falling under (i) above will be permitted to "opt in" so that they can have the passport, and the Directive calls on the Commission to adopt Level 2 implementing measures to facilitate and build a process around this.

The following categories of AIFM are therefore subject to the Directive:

- (i) an AIFM established in the Community providing management services to one or more non-UCITS schemes which are domiciled in the Community; and
- (ii) an AIFM established in the Community providing management services to one or more non-UCITS schemes which are not domiciled in the Community and which is marketing one or more such non-UCITS in the Community.

#### **Categories of AIFM subject to the Directive – lack of clarity**

*AIFM established outside of the Community managing non-UCITS established in the Community*

It is not clear from Article 4 of the Directive whether an AIFM which is established outside of the Community and which is providing management services to one or more AIF domiciled within the Community is required to be authorised by the Member State in which the AIF is established. It would appear to us that the act of providing management services to a European non-UCITS is likely to be considered to be the provision of “*management services to AIF ... within the Community*” for the purposes of Article 4. If that is the proper interpretation, then, according to Article 4, such an AIFM would be required to be authorised, however, it is not clear whether such an AIFM is required to establish a registered office in the Community and be authorised pursuant to Article 5 of the Directive or whether it can be authorised “in accordance with the national law of a Member State” as suggested by Article 4.

*AIFM established outside of the Community marketing non-UCITS domiciled outside of the Community into the Community*

If an AIFM established outside of the Community wished to market within the European Community a non-Community AIF of which it was manager, then Member States would have the discretion to authorise the AIFM to market the shares of the AIF to professional investors within the Community under Article 39 of the Directive (“Authorisation of AIFM established in third countries”). However, it appears that Member States are not able to authorise non-Community AIFM to manage AIF within the Community either under Article 5 or Article 39 and the ability of a Member State to authorise such managers “in accordance with the national law of” the Member State as suggested by Article 4 needs to be clarified. It remains to be determined by the Commission what exactly will be required of a third country’s prudential regulation and on-going supervision of AIFM established on its territory in order for such third country to be an approved non-Community jurisdiction for the purposes of Article 39. For example, would the AIFM be required to ensure that for each AIF it manages a depositary and valuator are appointed? This would seem to be necessary to ensure a level playing field between AIFM established in the Community and those established elsewhere. This aspect of the Directive will need to be clarified by the Commission.

*“Self-managed” non-UCITS established inside or outside the Community*

Another matter that will need to be addressed by the Commission is whether investment managers which are appointed directly by what might be referred to as “self-managed” non-UCITS which do not have a management company and which are not responsible for “management services” in the broad sense as defined in the Directive (i.e. the activities of managing and administering one or more AIF on behalf of one or more investors) are intended to be subject to this Directive and can avail of the benefits of the Directive such as the passporting opportunities for AIF. It may be that the Commission’s intention was that non-UCITS could only be marketed in the Community to professional investors if the AIF appointed an AIFM that was authorised under the Directive to provide management services to the AIF.

One of the stated premises of the Directive (see the Commission's Impact Assessment which accompanied the Directive (COM (2009) 207, SEC(2009) 577) is that AIF will generally have management companies that are responsible for management and administration and that such management companies are typically located on-shore in the EU. This is certainly not always the case and it is still relatively common, for example, for the management company of Cayman hedge funds to be a Cayman company, the investment manager to be UK based and the administrator to be based in Ireland.

*Persons established within the Community providing portfolio management services but not management services to AIF*

Recital 5 of the draft Directive provides inter alia that "Investment firms authorised under Directive 2004/39/EC on Markets in Financial Instruments should not be required to obtain an authorisation under this Directive in order to provide investment services in respect of AIF." One can only surmise that the purpose of this was to clarify that the investment management as opposed to management of a non-UCITS by a firm authorised under MiFID would not require a separate authorisation. However, Article 18(1)(b) of the draft Directive provides that where an AIFM intends to delegate portfolio management or risk management to a third party, the third party must also be authorised as an AIFM to manage an AIF of the same type. This means that MiFID authorised investment managers who are acting as investment managers of AIF by delegation from authorised AIFM, will be required to seek authorisation under the Directive. It would appear that such firms will have to go through the normal authorisation process of Article 5.

The Rasmussen Report originally sought to apply its proposed requirements to the "entity that controls the investment of the fund concerned" rather than on the "manager" of the fund as such. The Explanatory Memorandum that accompanied the draft Directive explained that the Commission chose to regulate the managers as oppose to investment managers because the risks to market stability, efficiency and investors stem primarily from the conduct and organisation of the management companies of these AIF and certain other key actors in the fund governance and value-chain (depository bank where relevant and valuation entity).

**Authorisation of AIFM established in a Member State**

Article 5 of the Directive provides that an AIFM applying for authorisation must provide the following to the competent authority in the Member State where it has its registered office:

- (i) its constitutive document;
- (ii) a programme of activity;
- (iii) details of any persons holding or controlling 10% or more of the capital or voting rights of the entity, directly or indirectly;

- (iv) detailed information about each AIF which the manager proposes to manage, including the fund rules;
- (v) details of any delegation to third parties of management services;
- (vi) information on the arrangements for the safe-keeping of the assets of the AIF; and
- (vii) detailed information which the AIFM is required to disclose to investors before they invest in the AIF (Article 20) such as details of the AIF's investment strategy and objectives, risks, investment restrictions, circumstances in which the AIF can use leverage, identity of the AIF's depositary, valuator, auditor and other service providers, a description of the AIF's valuation procedures, liquidity risk management, fees and expenses and latest annual report.

A Member State can grant authorisation only if it is satisfied that the AIFM will be able to fulfill the conditions of the Directive (including the operating conditions described below) and may restrict the scope of an authorisation as regards the type of AIF as well as the delegation arrangements.

#### **AIFM authorised in one Member State and providing Management Services in other Member States**

Article 34 of the Directive enables AIFM authorised in one Member State to provide management services to AIF domiciled in another Member State either on a freedom of establishment basis or freedom to provide services basis provided that the AIFM's home Member State authorisation extends to the management of that type of AIF and subject to the AIFM communicating the following information to the home Member State regulator:

- (i) the Member State in which it intends to provide management services;
- (iii) a programme of operations identifying the AIF it intends to manage and the services it intends to provide;
- (iv) (if applicable) the organizational structure of the branch including the identities of the persons responsible for its management; and
- (v) (if applicable) the address in the home Member State from which documents may be obtained.

The host Member States are not permitted to impose any additional requirements on the AIFM in respect of matters covered by the Directive.

#### **AIFM marketing AIF within the Community**

The definition of "marketing" in the Directive is "any general offering or placement of units or shares in an AIF to or with investors domiciled in the Community, regardless of at whose

initiative the offer or placement takes place”. It appears that this definition will bring offers or placements that are more significant than placements to a single investor into scope and will include offers based on the notion of “reverse solicitation”.

#### *Marketing AIF in AIFM's home Member State*

An AIFM established and authorised in a Member State or an AIFM established outside of the Community that is authorised by a Member State under Article 39 (the “home Member State”), can market shares of AIF to professional investors (as defined in Annex II of Directive 2004/39/EC (MiFID)) in the AIFM's home Member State and that AIF which have AIFM authorised in this way may be marketed in this way by MiFID authorised firms once the AIFM makes the notifications required under Article 31 to the Member State:

- (i) identification of the AIF and the domicile of the AIF;
- (ii) the AIF's constitutive document;
- (iii) a description of the AIF and any information on the AIF available to investors;
- (iv) information on the arrangements established to prevent units or shares of the AIF from being marketed to retail investors.

Any AIFM wishing to market an AIF that is not domiciled within the European Community may only do so if *in addition* the country in which the AIF is domiciled has signed an agreement with the Member State to which such AIFM has applied for permission to market, that is consistent with Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information in tax matters and the Member State in question.

Until the expiration of the three year transitional period following the adoption of the Directive, AIFM will be permitted to market within the Community AIFs that are established outside the Community subject to national inward marketing rules in each Member State.

#### *Marketing AIF into Member States other than the AIFM's home Member State*

Authorised AIFM can market AIF that they manage to professional investors in a Member State other than the one in which the AIFM is authorised provided that it submits the following documents to the competent authority of its home Member State:

- (i) a notification letter including a programme of operations identifying the AIF it intends to market and where it is domiciled;
- (ii) the AIF constitutive document;
- (iii) a description of the AIF and any information on the AIF available to investors; and
- (iv) information on the arrangements established to prevent units or shares of the AIF from being marketed to retail investors.

*AIFM established outside the European Community – authorisation to market AIF under Article 39*

If an AIFM established outside of the Community wished to market an AIF of which it was manager within the European Community, then Member States would have the discretion to authorise the AIFM to market the shares of the AIF to professional investors within the Community under Article 39 of the Directive (“Authorisation of AIFM established in third countries”).

A Member State has the discretion to approve such an AIFM under Article 39 if;

- (i) the Commission decides that the legislation in the country in which the AIFM is established is equivalent regarding prudential regulation and on-going supervision to the provisions of the Directive and is effectively enforced;
- (ii) the Commission decides that the country in which the AIFM is established provides Community AIFM effective market access comparable to that granted by the Community to AIFM from that country;
- (iii) the AIFM provides the Member State in which it is applying for authorisation with the same information as an AIFM established in the Community and seeking authorisation in the Member State under Article 5 would have to and as an authorised AIFM seeking to market shares of an AIF in another Member State under Article 31 would have to;
- (iv) a cooperation agreement between the competent authorities of that Member State and the supervisor of the AIFM which ensures an efficient exchange of all information that is relevant for monitoring the potential implications of the activities of the AIFM for the stability of systematically relevant financial institutions and the orderly functioning of markets in which the AIFM is active; and
- (v) the country in which the AIFM is established has signed an agreement with the Member State that is consistent with Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information in tax matters.

On the face of it, it may be more straightforward for non-Community managers to establish an AIFM in the Community and become authorised under the Directive.

*Marketing AIF within the Community to retail investors*

The Directive authorizes Member States to permit the marketing of AIF to retail investors under national law subject to the minimum requirements of the Directive and such stricter requirements that the Member State may impose.

### **Operating Conditions for AIFM**

The Directive prescribes a number of broad conduct of business requirements for AIFM such as;

- a duty to act honestly, with due skill, care and diligence and fairly in conducting its activities and to act in the best interests of the AIF it manages, the investors of those AIF and the integrity of the market;
- that the AIFM structure its internal organisation such that risk and portfolio management are separated and to implement risk management systems in order to measure and monitor all risks associated with each AIF investment strategy;
- to implement an appropriate, documented and regularly updated due diligence process when investing on behalf of an AIF, according to the investment strategy, objective and risk profile of the AIF; and
- to appropriate liquidity management system to ensure that the liquidity profile of investments of the AIF complies with its obligations, regularly conduct stress tests and ensure that the AIF has a redemption policy that is appropriate to the liquidity profile of the AIF's investments.

### **AIFM capital requirements**

Under the proposal, AIFM authorised under the Directive will be obliged to maintain own funds which must be the higher of; (i) one quarter of fixed annual overheads; and (ii) €125,000 plus 0.02% of the amount by which the value of the AIF portfolios under management by the AIFM exceeds €250 million.

It is worth noting that these requirements are potentially less onerous than apply to portfolio managers under MiFID but are more onerous than apply to UCITS Management Companies under the UCITS Management Company Directive because of the absence of the €10 million "cap" on capital for AIFM.

### **AIFM organisational requirements**

The general requirement is that the AIFM has sufficient resources to conduct its business and specifically that it have updated systems, documented internal procedures and internal controls to mitigate and manage risk.

### *Valuator*

The proposed Directive would also introduce a rule (under Article 16) obliging an AIFM to appoint a valuator that is independent of the AIFM to establish the value of assets acquired by the AIF and the value of the shares and units of the AIF (the “Valuator”).

At first glance it would appear that as long as an AIF has appointed an independent administrator established in the Community, which is the common model in the European hedge fund industry, this requirement should be capable of being complied with easily. However, this proposal touches on a long-running debate in fund administration and fund management circles regarding responsibility for valuation, particularly of assets which are valued other than on the basis of their market price and have to be valued at fair value or probable realization value. It seems intuitive to some that the administrator would undertake these and all other valuations, however, in practice administrators tend not to see themselves as valuation agents and leave the valuation of (or at least responsibility for) off-market or illiquid assets to expert pricing agents or the governing bodies of the funds in question. This practice is in line with the recommendations of IOSCO and AIMA and others in this area. Administrators will be keen to limit the extent to which they will be required to take responsibility for such valuations. It would appear from Article 16 that the Directive does not require the Valuator to necessarily take responsibility for the valuation, rather it just requires that the activity of valuation be undertaken by the Valuator. It would seem to be still open to Valuators and AIFM to agree that the ultimate responsibility for the valuation still rests with the AIFM or the governing body of the AIF.

If the Valuator is appointed by the AIFM by delegation then the requirements of Article 18 (Delegation) will apply. Among the requirements of Article 18 is a requirement that if any delegation by the AIFM concerns the portfolio management or the risk management, the third party must also be authorised as an AIFM to manage AIF of the same type. Administrators which provide foreign exchange services and middle office risk functions, which is not uncommon, might be required on this basis to be authorised as AIFM. Importantly, Article 18 provides that “in no case shall the AIFM’s liability be affected by the fact that the AIFM has delegated functions to a third party, nor shall the AIFM delegate its functions to the extent that, in essence, it can no longer be considered to be the manager of the AIF”. A similar provision is found in Article 5 of the UCITS Directive which provides that “in no case shall the management company’s...liability be affected by the fact that the management company delegated any functions to third parties, nor shall the management company delegate its functions, to the extent that it becomes a letter box entity.” Article 18 further provides that “the third party may not sub-delegate any of the functions delegated to it”. This latter provision certainly needs clarification as the common practice among administrators of “off-shoring” or delegating certain core and non-core services to affiliated or unaffiliated entities would seem to be prohibited by this requirement.

Article 37 provides that Member States shall only allow the appointment of a Valuator established outside of the Community provided that the general requirements for Valuators set out in Article 16 are fulfilled and provided that the Commission has determined that the valuation standards and rules used by Valuators established on its territory are equivalent to those applicable in the Community.

#### *Depository bank*

The Directive would also introduce radical rules regarding the appointment and liability of depository banks to safe-keep the assets of AIF. The rules would oblige each AIFM to ensure that any AIF that it manages appoints an EU credit institution as a depository (i.e., custodian) to undertake, “where relevant”, the following tasks:

- (i) receive all payments made by investors when subscribing shares of an AIF managed by the AIFM and book them on behalf of the AIFM in a segregated account;
- (ii) safe-keep any financial instruments which belong to the AIF; and
- (iii) verify whether the AIF or AIFM on behalf of the AIF has obtained ownership of all other assets the AIF invests in.

The terms “where relevant” and “which belong to the AIF” are significant here. There may be scenarios where an AIF may be required to pass margin or collateral on an outright transfer of ownership basis to counterparties with which the AIF is trading over-the-counter, to open margin accounts with securities or futures clearing brokers and the like. It would appear to be unworkable if the Directive was to require any such transferred assets to be safe-kept by the depository or its sub-depositaries.

The proposal provides that “in the case of any loss of financial instruments which the depository safe-keeps, the depository can only discharge itself of its liability if it can prove that it could not have avoided the loss which has occurred” and that liability can be invoked either directly or indirectly through the AIFM depending on the legal nature of the relationship between the depository, the AIFM and the investors.

The depository must act independently and solely in the interest of AIF investors, which denotes a fiduciary responsibility that may, depending on the applicable law, impose obligations and responsibilities and restrictions over and above those imposed on pure safe-keeping agents.

The Directive permits depositaries to delegate “to other depositaries” however the “depository’s liability shall not be affected by any such delegation”. With respect to AIFs domiciled in non-Community countries, the proposal suggests (Article 38) that the AIF’s depository may delegate its depository tasks to a sub-depository domiciled in the same non-Community country as the relevant AIF, provided that the legislation of the relevant country

provides a level of protection of investor interests that is equivalent to that in the Community. In order for the AIF depositary to delegate to such a sub-depositary; (i) the Commission must have determined that sub-depositaries domiciled in the country in question are subject to effective prudential regulation and supervision which is equivalent to the provisions laid down in Community law; (ii) co-operation between the home Member State and the relevant authorities of the third country is sufficiently ensured; and (iii) the Commission has determined that the country in question has standards to prevent money laundering and terrorist financing that are equivalent to those laid down in Community law.

Article 18 (Delegation) provides that “no delegation shall be given to the depositary...or to any other undertaking whose interests may conflict with those of the AIF”. It should be made clear in the re-draft or the Commission’s Level 2 measures that this will not prohibit delegation where the depositary may have a trading relationship with the AIF, for example, where the AIF is appointing a prime broker.

The difficulties with the depositary proposals are first of all that the hedge fund and private equity fund models do not typically involve the appointment of a dedicated depositary bank at all and secondly, to the extent that entities are acting as depositaries to non-UCITS within the Community, the majority are not credit institutions. Many single strategy hedge funds assets are custodied by their prime brokers, a majority of which are not credit institutions.

The proposals can be contrasted with Article 7 of UCITS Directive 85/61/EEC as amended which provides that a depositary must be an institution which is subject to public control, that must furnish sufficient financial and professional guarantees to be able effectively to pursue its business as depositary and meet the commitments inherent in that function, but the depositary is not required to be a credit institution: it is left to the Member States to determine which categories of institutions referred shall be eligible to be depositaries. In Ireland, for example, depositaries of Irish UCITS may be Irish credit institutions or branches of EU credit institutions or Irish incorporated companies that are wholly owned and guaranteed by EU credit institutions or by non-EU institutions if the Irish Regulator deems such institutions equivalent to EU credit institutions or by Irish incorporated companies that are wholly owned and guaranteed by EU or non-EU institutions which the Irish Regulator deems provides an equivalent level of investor protection to investors as EU credit institutions. The UCITS Directive does not prescribe whether sub-depositaries must be credit institutions or not and whether and under what conditions such sub-depositaries can be domiciled outside of the European Community.

There appears to be a fundamental problem with significantly restricting the ability of the depositary to delegate depositary activities outside of the Community: for example, an emerging market hedge fund will presumably require depositaries local to the markets where the assets are located.

The other major issue with this proposal is the level of legal responsibility imposed on the depositary. In the case of any loss of financial instruments which the depositary safe-keeps, the depositary can only discharge itself of its liability if it can prove that it could not have avoided the loss which has occurred. Contrast this position with Article 16 of the UCITS Directive states that a depositary shall "in accordance with the national law of the state in which the investment company's registered office is situated" be liable to the UCITS and its investors for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance of them" and that a depositary's liability is not affected by it having entrusted some or all of the assets in its safe keeping to a third party, however, the burden of proof of the UCITS Directive has been inverted in the proposed Directive such that the depositary must establish that it could not have avoided the loss, otherwise it will be liable for any loss of financial instruments in its safe-keeping. It should be borne in mind however that this liability standard only applies to losses of financial instruments and not to liability for the depositary's broader responsibilities as custodian. Also, it is understood that the Commission, which has undertaken an extensive examination of the implementation of UCITS Article 16 in the Member States and has identified that the minimum standards were implemented in divergent ways across the Member States, intends to apply this inverted standard of liability to UCITS.

### **Delegation**

AIFM which delegate to third parties the carrying out of one or more management functions must request prior authorisation from the competent authority of the home Member State for each delegation.

An AIFM established in the Community and seeking authorisation under Article 5 or an AIFM established outside of the Community seeking authorisation under Article 39 must as a condition of such authorisation provide details of any delegation to third parties of management services.

The third party delegate must be creditworthy and the persons conducting the business must be of good repute and experience. Where the delegation concerns portfolio management or risk management, the third party must also be authorised as an AIFM to manage an AIF of the same type. The delegation must not prevent the effectiveness of supervision of the AIFM. Importantly, in no case shall the AIFM's liability be affected by the fact that it has delegated functions to a third party nor can it delegate functions to the extent that, in essence, it can no longer be considered to be the manager of the AIF.

A particular requirement that will make it difficult for multi-manager funds and funds which use sub-managers or sub-advisors is that "third party may not sub-delegate any of the functions delegated to it". This appears to be too prescriptive and from an investor's point of view the principal concern should be disclosure and the fact that the AIFM's liability is not affected by such delegation.

Article 36 provides that Member States shall only allow an AIFM to delegate administrative services to entities established outside of the Community provided that all of the following conditions are met:

- (i) the requirements set out in Article 18 (Delegation) are fulfilled;
- (ii) the entity is authorised to provide administration services or registered in the third country in which it is established and is subject to prudential supervisions;
- (iii) there is an appropriate co-operation agreement between the competent authority of the AIFM's home Member State and the supervisory authority of the entity.

### **Transparency**

Under the proposed Directive, an AIFM would be required to disclose certain information to investors, both prior to investing and on an ongoing basis periodically, would be required to make an annual audited report available to investors and the appropriate national regulator and to regularly report to the appropriate national regulator.

The information which an AIFM would be required to give to investors before they invest in an AIF is largely what would be disclosed in a typical fund offering document, though in some cases the Directive is a little too all-encompassing in the scope of its required disclosures:

- a description of the investment strategy and objectives of the AIF, all the assets which the AIF can invest, any applicable investment restrictions including leverage restrictions;
- the identity of the AIF's depositary, valuator, auditor and any other service providers and a description of their duties and the investor's rights should any failure arise;
- a description of any delegated management or depositary function and the identity of the third party to whom the function has been delegated;
- a description of the AIF's liquidity risk management, including the redemption rights both in normal and exceptional circumstances, existing redemption arrangements with investors, and how the AIFM ensure a fair treatment of investors; and
- a description of all fees, charges and expenses

Certain specific disclosures required by the Directive might not be typically disclosed, including the following;

- the types and sources of leverage permitted;

- a description of any legal instruments providing for the recognition and enforcement of judgments on the territory where the AIF is domiciled;
- a description of the AIF's valuation procedure and where applicable of the pricing models for valuing assets, including the methods used in valuing hard-to-value assets; and
- whenever an investor obtains a preferential treatment or the right to obtain preferential treatment, the identity of the investor and a description of that preferential treatment.

Periodically, AIFM would be required to disclose to investors:

- the percentage of AIF's assets which are subject to "special arrangements" arising from their illiquid nature, which would appear to cover the use by AIF of side-pockets;
- any new arrangements for managing the liquidity of the AIF; and
- the current risk profile of the AIF and the risk management systems employed by the AIFM to manage these risks.

In addition, AIFMs would be required to report "regularly" to the appropriate national regulator, on matters including:

- aggregated information on the main instruments, markets of which it is a member or where it actively trades, and on the principal exposures and most important concentrations of each of the AIF it manages;
- the percentage of the AIF's assets that are subject to "special arrangements" arising from their illiquid nature;
- any new arrangements for managing the liquidity of the fund;
- the current risk profile of the AIF and the risk management systems used;
- the main categories of assets in which the AIF invested;
- where relevant, the use of short selling during the reporting period; and
- a list of each AIF which the AIFM manages as of the end of each quarter

## Obligations regarding AIFM managing specific types of AIF

### *Leveraged AIF*

The Directive as proposed will require AIFM which manage one or more AIF employing high levels of leverage on a systematic basis to disclose to investors the maximum level of leverage which the AIF may employ as well as any right of re-use of collateral or any guarantee granted under the leverage arrangement and, on a quarterly basis, the total amount of leverage employed by the AIF in the preceding quarter.

The AIFM will need to report to its home Member State the overall level of leverage of each of its AIF and a break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives, including the five largest sources of borrowed cash or securities for each AIF and the amounts of leverage received from each.

The term “high level of leverage on a systematic basis” is somewhat misleading as it defined in the Directive to be the combined leverage of the AIF from all sources in excess of the total equity of the AIF in two out of the past four quarters.

Importantly, the Directive envisages the Commission adopting implementing measures setting limits to the level of leverage AIFM can employ, which limits should take into account, inter alia, the type of AIF, their strategy and the sources of their leverage. The Directive also permits the AIFM’s home Member State, “in exceptional circumstances and when this is required in order to ensure the stability and integrity of the financial system”, to impose additional limits to the level of leverage that AIFM can employ.

### *AIF with controlling influence in companies*

Where AIFs managed by an AIFM take significant stakes (over 30% of the voting rights) in non-listed companies that have more than 250 employees, an annual turnover in excess of €50 million and/or an annual balance sheet that exceeds €43 million, the AIFM would be required to provide a notification and disclosures to the target company and its shareholders, as well as the target company’s employee representatives, not later than four trading days after the AIFM becomes able to exercise 30% of the voting rights. The notification must contain:

- ▣ the resulting situation in terms of voting rights;
- ▣ the conditions under which the 30% threshold has been reached, including information about the identity of the different shareholders involved; and
- ▣ the date on which the 30% threshold was reached or exceeded.

The disclosures include:

- the identity of the AIFM which (either individually or in agreement with other AIFMs) has reached the 30% threshold;
- a development plan for the non-listed company;
- the policy for preventing and managing conflicts of interests, in particular between the AIFM and the non-listed company; and
- the policy for external and internal communication of the issuer or non-listed company, in particular as regards issues affecting its employees.

### **Current Position pre-Directive**

Currently, the activities of AIFM established in the European Community are regulated by a combination of national financial law regulations and general provisions of Community law. AIFM established outside of the Community which have no place of business within the Community which are providing management services or investment management services to AIF established within the Community are generally exempt from the requirements of MiFID but may be subject to a requirement to register with the local Member State regulator under national financial law. Investment managers established with the Community that are not managers, in the sense of providing administration services as well as investment management services, are regulated in their provision of portfolio management services under Article 5 of MiFID. Article 2(1)(h) of Directive 2004/39 (MiFID) provides an exemption for nationally regulated funds within the Community and their managers and depositories but only to the extent that the activities of the entities are already regulated. If non-UCITS are sold or advised on by European intermediaries, those intermediaries are generally subject to MiFID unless the funds are regulated in Europe and the intermediaries are acting in their capacity as managers of the funds or come within one of the other exemptions from MiFID set out in its Article 2 and/or Article 3.

The national rules and general provisions are supplemented in some areas by industry-developed standards. Numerous different hedge funds and private equity initiatives and organisations such as the International Organization of Securities Commissions, the International Monetary Fund, the Organisation for Economic Co-operation and Development and industry bodies, such as the Alternative Investment Management Association, the Managed Funds Association, the Hedge Fund Standards Board and the Presidents Work Group on Financial Markets, have established principles and codes of best practice over the past number of years.

Non-UCITS hedge funds and private equity funds are sold within the European Community under a patch-work of national private placement rules where such rules exist. Certain countries, for example, France and Italy, do not permit the placement of foreign non-UCITS in their territories without registration with the local regulatory authorities.

The proposed Directive is intended to overcome gaps in national regulations and to provide a basis for the development of an internal market.

### **What next?**

This Directive is a so-called “Lamfalussy” Directive. Under the Lamfalussy process, Parliament and Council will now look to adopt the Directive under the co-decision procedure. This is known as “Level 1” in the Lamfalussy process. The Parliament’s Committee on Economic and Monetary Affairs (ECON) will carry the Directive forward. The membership of ECON will be determined over the summer and ECON will appoint a rapporteur to steer the Directive through the committee stage and a draftsman from the Juri Committee will also be appointed. The rapporteur and the members of ECON and any other parliamentary committee may propose amendments to the Commission’s proposal. These amendments, together with those proposed by any other parliamentary committees asked for an opinion are put to the vote in ECON, on the basis of a simple majority. Once the report is adopted in ECON, it is placed on the agenda of the plenary session of the European Parliament. In practice, this phase lasts for eight months on average but may take longer depending on the complexity of the legislation.

Meanwhile in Council, the proposed Directive is first considered by working parties made up of experts from the Member States and chaired by the Member State holding the six-monthly Presidency of the Council. This preparatory work runs concurrently with the European Parliament’s activity. The conclusion of the working parties’ discussions is known as the orientation generale, and usually forms the basis of Council’s position at the end of the first reading.

In order for the proposal to become law, Council and Parliament must approve each other’s amendments and agree upon a final text in identical terms. If the two institutions have agreed on identical amendments after the first reading, the proposal becomes law; this happens occasionally, either where there is an early general consensus or where there is time pressure to adopt the legislation. Otherwise, there is a second reading in each institution, where each considers the other’s amendments. If the institutions are unable to reach agreement after the second reading, a conciliation committee is set up and the committee attempts to negotiate a compromise text which must then be approved by both institutions in a third reading. Decisions at Council are by qualified majority voting.

Once the Directive is adopted, the implementing powers phase, Level 2, begins. The Commission adopts the measures implementing the Level 1 Directive on the basis of the comitology process. The Commission can only adopt Level 2 measures in those areas where the Level 1 Directive specifically gives it the power to do so. The Commission first consults the European Securities Committee (ESC) and also requests advice from the Committee of European Securities Regulators (CESR). More specifically, following a mandate granted by the Commission, CESR prepares technical advice in consultation with

market practitioners, end-users and consumers, and forwards it to the Commission. On the basis of this advice, the Commission draws up draft implementing measures, which are then submitted to the ESC for vote. The Commission adopts the implementing measures once the ESC has approved them. The process is undertaken in consultation with the Parliament.

The draft Directive has proven to be very controversial so far, both from the perspective of the Party of European Socialists which was the driving force behind it, which believes that it did not go far enough and will encourage regulatory arbitrage, and the industry which it seeks to regulate, which believes the draft Directive is in many respects unworkable and that its one-size fits all approach fails to recognize the way in which different non-UCITS fund business models work. Concern has also been raised that the Directive is overly protectionist and may drive non-UCITS managers out of Europe and effectively prevent non-European managers, administrators and depositaries from servicing non-UCITS being marketed in Europe. There is also a feeling that the Directive was premature given that so much work is being undertaken internationally on re-shaping the regulatory architecture in the financial markets and may end up being out-of-step with other markets and may make Europe uncompetitive.

Bodies such as AIMA are currently mobilizing the industry in order to present these and other arguments to the relevant institutions in Europe. Those who believe that the Directive will be significantly amended prior to adoption should bear in mind that there were many politically controversial provisions in the MiFID Directive at Level 1, yet in the end that Directive was implemented under the co-decision procedure without much fuss.

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