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Update on the Proposed European AIFM Directive

The European Council of Ministers and the European Parliament have each recently adopted their respective versions of the proposed EU Directive on Alternative Investment Fund Managers. This memorandum highlights some key similarities and differences between the proposals of the Council, the Parliament and the original Proposed Directive.

Background

The original text of the proposed Directive on Alternative Investment Fund Managers (the "Proposed Directive") was published by the European Commission on April 30, 2009. The legislative process to agree on a final text of the Proposed Directive has since been subject to unprecedented attention, debate and criticism. In order for the Proposed Directive to be adopted, the European Council of Ministers (the "Council") and the European Parliament (the "Parliament") need to approve a common text under the European Union's "codecision" procedure.

The Presidency of the Council published a compromise proposal on March 11, 2010, which is referred to in this note as the "Compromise Proposal". The Council voted on May 18, 2010 to adopt the Compromise Proposal as its agreed position.

The Parliament's Committee on Economic and Monetary Affairs ("ECON") voted on May 17, 2010 to adopt its final proposal, the draft proposal of which provides an indication of Parliament's agreed text and is referred to in this note as "Parliament's Proposal".

These competing texts will serve as the basis for negotiations at a series of "trilogue" meetings, which are taking place throughout June between representatives of the Parliament, Council and Commission. Once a compromise text is agreed, it will need to be adopted by a plenary session of the Parliament. At present, the indicative date for the plenary vote is July 6, 2010.

To the extent that the Compromise Proposal and the Parliament's Proposal are broadly in agreement on any particular issue, this is at least indicative of the direction that the final text of the Proposed Directive may take.

The main contentious issues are the proposals for non-EU ("third-country") managers and funds, depositary arrangements, remuneration, disclosure and valuation proposals. Each of these issues is addressed in this publication.

This note summarizes what appear likely to be the main features of the final Directive, each of which are dealt with at the section of this publication set out below:

1. Compulsory authorization
2. What is an AIFM?
3. *De minimis* exemptions
4. Marketing EU-domiciled funds
5. Management and marketing of non-EU funds
6. Marketing to retail investors
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19. Controlling influence disclosure

This note also includes details of the Commission's recent proposals to amend the regulation of credit rating agencies and discusses the implications for alternative investment funds.

1. Compulsory authorization

Under each proposal, managers located in the EU will require authorization from regulators in order to manage funds.[1] Managers may be authorized to manage all types of fund or only specific types.[2] The Compromise Proposal suggests that fund managers may be authorized to manage funds in accordance with "all or certain investment strategies". Parliament's Proposal clarifies that authorized fund managers must comply with the initial requirements for authorization at all times.

2. What is an AIFM?

The Commission and Parliament each propose that alternative investment fund managers ("AIFM") be defined as any natural or legal person who regularly manages funds.[3] The Council removes the idea that a 'natural person', i.e., an individual, may be an AIFM.

The Parliament's Proposal differs from the Compromise Proposal by stipulating that an AIFM is a fund manager that is responsible for the compliance with the Proposed Directive. Fund managers are unlikely to be able to avoid regulation under the Proposed Directive by merely stating that they are not responsible for compliance with the Directive.

The Compromise Proposal and Parliament's Proposal acknowledge that some funds may effectively be "self-managed" (in which case it is the fund itself that is the AIFM) while others have external managers (in which case it is that external manager that is the AIFM). In addition, it is made clear that each fund must have no more than one AIFM.[4] Self-managed funds will not be allowed to also be the external manager of other funds.

The Parliament's Proposal suggests that UCITS, banks and pension funds only investing their own money, supranational institutions, and holding companies which do not grant shareholders any redemption or repurchase rights should be excluded from the scope of the Proposed Directive.

3. *De minimis* exemptions

<u>Proposed Directive</u>: The Commission proposes that small fund managers would fall outside the scope of the Proposed Directive. For this purpose, different thresholds are effectively applied to private equity fund managers (those managing funds with less than €500 million of assets under management, which do not use leverage and which lock investors in for at least five years) and hedge fund managers (those managing funds with less than €100 million of assets under management).[5]

<u>Compromise Proposal</u>: The Council retains the *de minimis* exemptions referred to above, but each Member State will have the option as to whether or not to implement the exemptions.[6]

An AIFM which benefits from the *de minimis* exemption (if the exemption is implemented by the home Member State of the AIFM) will not be entitled to benefit from the rights under the Proposed Directive to market and provide its services in other Member States.[7]

Small fund managers benefiting from the *de minimis* exemption will still be subject to registration and limited reporting requirements in the relevant Member State.[8]

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1 Proposed Directive Article 4.

2 Proposed Directive Article 4(2).

3 Proposed Directive Article 3(b).

4 Council Compromise Proposal Article 3a(1).

5 Proposed Directive Article 2(a).

6 Council Compromise Proposal Article 2a(1)(a). The Council also proposes that the Commission should adopt implementing measures clarifying how the issue of the *de minimis* exemption thresholds should be dealt with.

7 Council Compromise Proposal Article 2b(3).

8 Council Compromise Proposal Article 2b(2).

Parliament's Proposal: The Parliament's Proposal adopts a more limited *de minimis* exemption by partially exempting 'non-systemically relevant' fund managers from the more onerous requirements under the Proposed Directive. 'Non-systemically relevant' fund managers would be managers which are not leveraged, whose individual assets under management do not exceed €100 million and in total do not exceed €250 million and which have no redemption rights exercisable for a period of five years from each fund's date of constitution.[9]

Parliament's approach is explicitly to include the requirement that the Proposed Directive be applied 'proportionately' and therefore it is intended that certain types of funds will not be subject to the more onerous obligations of the Proposed Directive.

Fund managers such as those which provide management services to their parents or subsidiaries, which are 'non-systemically relevant' managers, or manage private equity funds, employee participation schemes or real estate funds will be partially exempt from certain requirements under the Parliament's Proposal. It is proposed that Member States' regulatory authorities will identify which types of funds will benefit from more lenient regulation.

The European Securities and Markets Authority ("ESMA") will be required periodically to review the criteria to be met in order to benefit from the lighter regime.

4. Marketing EU domiciled funds

Under the Proposed Directive, once authorized in a Member State a manager may manage and market a fund to professional investors[10] across Europe.[11] This ability to market on a pan-European basis is colloquially known as the "passport". The Council and Parliament's proposals restrict the passport so that an authorized manager may only market EU funds on a pan-European basis. The ability to market non-EU funds on a passported basis is therefore dropped, although Member States may choose or continue to allow such marketing to professional investors on their territory subject to national law, as discussed below.[12]

5. Management and marketing of non-EU funds

Proposed Directive: The Commission proposes that non-EU funds should only be capable of being marketed to professional investors three years after the final deadline for the implementation of the Proposed Directive. The non-EU jurisdiction in which the non-EU domiciled fund is based would have to enter into an agreement with the relevant Member State where the investors are located addressing compliance with the OECD Model Tax Convention (which governs the exchange of tax information between the relevant authorities).[13]

Compromise Proposal: As described above the ability to market non-EU funds on a passported basis is dropped. The Council adds new provisions relating to the management and marketing of non-EU funds by EU authorized managers.

Managers will only be permitted to manage a non-EU fund if: (i) the manager complies with all requirements of the Proposed Directive except for depositary and annual reporting requirements; and (ii) a cooperation agreement exists between the manager's regulator and the third country's regulator.[14]

Managers will be able to market such non-EU funds to EU professional investors provided: (i) they comply with all requirements of the Proposed Directive except depositary requirements; and (ii) a cooperation agreement exists between the manager's regulator and the third country's regulator.[15] Managers marketing non-EU funds will still be required to appoint entities (other than the AIFM itself) which will fulfill the

9 Parliament's Proposal Article 3(og).

10 "Professional Investors" has the meaning set out in the Markets in Financial Instruments Directive (Directive 2004/39/EC).

11 Proposed Directive Articles 2(1), 31 and 33.

12 Council Compromise Proposal Articles 31, 33 and 34b and Parliament's Proposal Article 33(1) and (8a).

13 Proposed Directive Article 35.

14 Council Compromise Proposal Article 34a(1).

15 Council Compromise Proposal Article 34b(1).

depositary functions required under the Proposed Directive and will be required to provide the identity of these entities to the manager's regulator.

Parliament's Proposal: Parliament retains the principle that authorized managers may market non-EU funds to EU professional investors provided the country in which the non-EU fund is domiciled: (i) enters a cooperation agreement with the manager's regulator to ensure efficient exchange of information and supervision of the fund; (ii) meets the Financial Action Task Force standard requirements to prevent money laundering and terrorist financing; (iii) complies with OECD Model Tax Convention standards; (iv) grants reciprocal market access to EU fund managers; and (v) recognizes and enforces judgments rendered in the EU on matters connected with the Proposed Directive.[16] In addition, the authorized fund manager must comply with all of the requirements of the Proposed Directive in managing the non-EU fund.

6. Marketing to retail investors

The Commission and the Council propose that Member States could, in their discretion, allow authorized managers to market funds to retail investors in their territories.[17]

In principle, Parliament retains the ability for Member States to allow the marketing of funds to retail investors. However, the Parliament's Proposal includes a provision that prohibits the marketing of a fund to retail investors if the fund invests more than 30% of its funds in other funds prohibited from being marketed in the EU (i.e. funds managed by authorized fund managers that are not EU funds and do not have adequate cooperation agreements in place).[18]

Member States which allow such marketing to retail investors will be required to inform the Commission and ESMA of the types of funds marketed and any additional requirements that Member States may impose for marketing to retail investors in accordance with ESMA guidelines.[19]

7. Marketing by non-EU fund managers

Proposed Directive: A non-EU manager would be able to obtain authorization under the Proposed Directive to market a fund to professional investors provided that the third country meets certain prudential supervision requirements, a cooperation agreement exists between the Member State where the manager is applying for authorization and the third country, the third country has signed a cooperation agreement complying with the OECD Model Tax Convention and the third country grants EU managers comparable market access to that granted by the Community.[20]

Compromise Proposal: Member States may choose to allow non-EU fund managers to market funds to professional investors provided: (i) the manager complies with requirements under the Proposed Directive to provide annual reports, disclose information to investors, report to the regulator and notify the regulator on acquiring control of a non-listed company; and (ii) a cooperation agreement exists between the manager's regulator and the third country's regulator for the purpose of systemic risk oversight and is in line with 'international standards'.[21]

Parliament's Proposal: Parliament retains in principle the Proposed Directive's provisions by allowing fund managers located outside the EU to market funds to EU professional investors provided the country in which the fund manager is domiciled (i) enters a cooperation agreement with the fund's regulator to ensure efficient exchange of information and supervision of the fund manager; (ii) meets the Financial Action Task Force standard requirements to prevent money laundering and terrorist financing; (iii) complies with OECD Model Tax Convention standards; (iv) grants reciprocal market access to EU fund managers; and (v) recognizes

[16] Parliament's Proposal Article 35(1).

[17] Proposed Directive Article 32 and Council Compromise Proposal Article 32(1).

[18] Parliament's Proposal Article 32.

[19] Parliament's Proposal Article 32(2).

[20] Proposed Directive Article 39.

[21] Council Compromise Proposal Articles 35.

and enforces judgments rendered in the EU on matters connected with the Proposed Directive.[22]

The regulatory authorities of the country in which the fund manager is established would also be required to enter an agreement to act as agents of ESMA in the supervision of such fund managers. This agreement would require the third country regulatory authorities to enforce the powers of ESMA under the Directive against the AIFM as necessary.[23]

The Compromise Proposal and Parliament's Proposal each limit the definition of 'marketing' to that done "at the initiative of an AIFM".[24]

Parliament's Proposal includes the stringent and radical provision that if a non-EU fund did not meet the requirements of the Proposed Directive explained above any investment in a non-EU fund by an EU-based professional investor would be prohibited. This ban on investors would apply even if the investments were made at the initiative of the investor rather than the fund manager and irrespective of whether the fund manager was domiciled in the EU. It is not clear whether existing investors in such non-compliant funds would be expected to liquidate their investments but such a liquidation of assets in non-EU funds which do not comply with the requirements of the Proposed Directive would be difficult for a significant number of investors.

8. Master-feeder structures and fund of funds

The Commission's draft does not contain any reference to the way in which master-feeder structures and fund of funds might be structured. However, the Council's Compromise Proposal stipulates that the European passport cannot be circumvented through master-feeder fund structures so that a fund which invests more than 85% of its assets in a master fund (or in more than one master fund where those master funds have identical investment strategies) would not be able to be marketed across the Community unless the master fund is established in a Member State and is managed by an authorized manager.[25]

Parliament's Proposal does not explicitly restrict fund of fund or master fund structures with regard to marketing funds to professional investors.

9. Authorization conditions

Regulators would only grant authorization if they were satisfied that the fund manager was able to fulfill the conditions of the Proposed Directive.[26] A regulator would have two months in which to consider the manager's application for authorization.[27] The Compromise Proposal and Parliament's Proposal include additional, more specific, conditions on a fund manager. The Compromise Proposal suggests that the relevant regulator should have six months to decide on the application while the Parliament's Proposal suggests that the regulator should have three months to consider the application.[28]

10. Remuneration

Proposed Directive: The Commission did not propose any provisions relating to the remuneration of authorized managers or their staff.

Compromise Proposal: The Council proposes detailed remuneration provisions[29] whereby an authorized manager needs to establish and apply remuneration policies for all staff (including principals) whose professional activities have a material impact on the risk profile of the manager or the funds it manages. Remuneration policies must not encourage risk-taking that is inconsistent with the business plan and risk profile of the fund.[30] A "substantial portion"[31] of variable remuneration would have to be deferred for

22 Parliament's Proposal Articles 39(1) and 35(1).

23 Parliament's Proposal Article 39(2) and (3).

24 Compromise Proposal Article 3(e) and Parliament's Proposal Article 3(e).

25 Council Compromise Proposal Articles 3(ga), 31 and 33.

26 Proposed Directive Article 6(1).

27 Proposed Directive Article 6(4).

28 Parliament's Proposal Article 6(4).

29 The detail is set out in a proposed new Annex II to the Compromise Proposal.

30 Council Compromise Proposal Article 9a and Annex II 1(a).

31 The Council has tentatively suggested that a "substantial portion" for this purpose would be at least 40%, or 60% in the case of "particularly high" bonuses.

an appropriate period,[32] and guaranteed bonuses would not be permitted except in the context of hiring new staff (and even then only for the first year of employment).[33]

The Council proposes that the Committee of European Securities Regulators ("CESR") (or its replacement, ESMA), in conjunction with the Committee of European Banking Supervisors (to be replaced by the European Banking Authority), should issue guidelines on remuneration policies.

In addition, authorized managers must disclose, both to regulators and investors, on request, the total amount of fixed and variable remuneration paid by the manager (or the fund, where applicable), broken down into categories such as "senior management".[34]

AIFMs that are significant in terms of the size of the funds they manage, their internal organization, scope and the complexity of their activities shall establish a remuneration committee to exercise competent and independent judgment on remuneration policies and practices.[35]

Parliament's Proposal: The Parliament's Proposal requires that AIFMs adopt sounds policies and practices that do not encourage excessive risk. It also specifically requires that remuneration policies for fund managers be more closely aligned to those to be applied to investment firms and banks. A fund manager must inform its regulator about the "characteristics of its remuneration policies and practices".[36]

11. Information required for authorization

Proposed Directive: Information to be supplied prior to authorization includes the planned activity, location and characteristics of the funds to be managed (including the instruments of incorporation and fund rules), the identities of shareholders in the manager that hold 10% or more of the capital, the amounts held by any such shareholders, governance mechanisms and arrangements for delegation and safe-keeping of assets.[37]

Compromise Proposal: The Council does not make any major amendment proposals on this issue but has recognized that some of the information, such as on delegation and sub-delegation, safe-keeping of assets and funds the manager intends to manage, may not be available to the manager when it applies for authorization.

Parliament's Proposal: The Parliament proposes that the manager must also provide information on the domiciles of underlying funds (in the case of fund of funds to be managed) and master funds (in the case of master-feeder structures).[38] The Parliament's Proposal specifies that information on the characteristics of the fund must include the investment strategies, use of leverage and risk profile of the fund. Where the fund is self-managed, details of the background and experience of the directors or members of the governing body would need to be provided.[39]

To ensure that fund managers that are also authorized under the UCITS Directive (2009/65/EC) are not required to submit duplicate information, Parliament has proposed that fund managers will not be required to submit information which has already been provided for the purpose of the original authorization under the UCITS Directive.

12. Valuators

Proposed Directive: The Commission proposes that a manager must appoint an independent valuator for each fund that it manages and must ensure that the valuator has appropriate and consistent procedures to value that fund's assets.[40]

Compromise Proposal: The Council dropped the general requirement that an independent third-party valuator must be appointed for each fund, although

[32] Council Compromise Proposal Article 9a, and Annex II 1(m). The period in question must be appropriate in view of the life cycle and redemption policy of the relevant fund to which the remuneration relates.

[33] Council Compromise Proposal Annex II 1(h).

[34] Council Compromise Proposal Article 19(2).

[35] Council Compromise Proposal Annex II 3.

[36] Parliament's Proposal Article 9.

[37] Proposed Directive Article 5.

[38] Parliament's Proposal Article 5(ca) and (cb).

[39] Parliament's Proposal Article 5(aa).

managers would be free to appoint third-party valuators if they wish. Instead, emphasis is placed on ensuring the independence of valuation from the portfolio management functions of an authorized manager, particularly when the fund manager receives a fee, commission or other payments linked to the performance of the fund.[41]

External valuers appointed by the AIFM must be professionally registered and have indemnity insurance and should be identified to the regulators by the AIFM. If the external valuer does not satisfy the required conditions, the regulator may require another external valuer be appointed.[42]

Where the valuation is not independent, the regulator of the Member State where the AIFM is established may require the fund manager to have its valuation procedures and/or valuations verified by an external valuer or auditor.[43]

Parliament's Proposal: The Parliament's Proposal follows the provisions of the Compromise Proposals by allowing fund managers to value their funds provided that there are adequate safeguards (Chinese walls) in place allowing the valuation function to be carried out independently. The fund manager will be required regularly to publish the methodologies used for the valuation of illiquid assets. The Parliament's Proposal accord with that of the Council in that where the valuation is not independent the regulator of the host Member State may require that the valuations are checked by an external body such as an auditor. Parliament's Proposal further specifies that the delegation of valuation tasks will not transfer the liability associated with such tasks from the fund manager to the external valuer.[44]

13. Depositaries

Proposed Directive: A manager must appoint an independent depositary to act solely in the interest of investors. An authorized manager cannot be a depositary. Only credit institutions recognized under EU law (i.e. banks) are eligible to be depositaries and may only delegate their functions to other EU depositaries. The depositary will be strictly liable to the manager and the fund for any losses suffered as a result of its failure to perform its obligations under the Proposed Directive. The depositary may only discharge its liability for any loss of financial instruments if it shows that it could not have avoided the loss.[45]

The original proposals relating to depositaries have been heavily criticized in previous months[46] and, as expected, each of the Council and the Parliament have proposed to extend the types of firms that may act as depositaries, although not to the same degree.

Compromise Proposal: Under the Council's proposals, authorized managers must appoint, as depositary, either: (i) an EU credit institution; (ii) an EU investment firm authorized to carry out depositary functions (this opens to door for many non-bank authorized firms in the EU to act as depositary); or (iii) any other EU institution which is subject to prudential regulation and ongoing supervision and which Member States consider to be eligible to be depositaries at the date the Proposed Directive comes into force.[47] Funds which are not leveraged and have no redemption rights exercisable during the five years from the date of initial investment in the fund may appoint an entity which carries out depositary functions as part of its business activities and complies with professional standards as its depository.

The restrictions on delegation are relaxed to some extent, so that custody functions may be delegated (including to sub-custodians in non-EU jurisdictions, provided that the sub-custodian is supervised in its

[40] Proposed Directive Article 16.

[41] Council Compromise Proposal Article 16.

[42] Council Compromise Proposal Article 16 (2a) and (2b).

[43] Council Compromise Proposal Article 16 (2d).

[44] Parliament's Proposals Article 16.

[45] Proposed Directive Article 17.

[46] See our previous client publication on the Proposed Directive, "Update on the proposed European AIFM Directive: Council and Parliament publish draft amendments" dated December 8, 2009 at http://www.shearman.com/update-on-the-european-directive-to-regulate-alternative-investment-fund-managers-09-25-2009/.

[47] Where the fund has no assets that are traded regularly on a regulated market or multilateral trading facility, a manager may alternatively appoint a

home jurisdiction, has sufficient expertise and meets certain other requirements, including the segregation of custody assets from its own assets).

The strict liability of a depositary is also relaxed. If a depositary can demonstrate that it has exercised all due skill, care and expertise in selecting and monitoring sub-custodians, it may disclaim liability (by contractual agreement) for a sub-custodian's inability to return assets to the fund.[48]

The depositary still remains strictly liable for all other breaches of its obligations, however, unless these occur as a result of abnormal and unforeseeable circumstances out of their control, or where their obligations to the fund or the managers conflict with national or EU law.

Parliament's Proposal: The Parliament also proposes to widen the categories of firms that are eligible to be depositaries to include EU authorized investment firms. Depositaries for non-EU funds managed by authorized AIFM will be required to have their registered office in the EU unless the third country supervisory authorities comply with certain requirements.[49]

The Parliament also recognizes that depositaries may need to delegate their functions and, broadly, would allow delegation except to the extent that the depositary becomes a "letter box entity" in doing so.[50] How much delegation would be permitted before a depositary becomes a "letter box entity" is not clear. A depositary will be able to delegate some of its tasks to a non EU sub-depositary provided it remains liable for the sub-depositary's actions, retains control over it, and the third country fulfils similar cooperation agreement conditions similar to those required from non-EU funds being marketed in the EU.

A depositary will remain liable for actions of sub-depositaries unless the depositary is legally prevented from exercising its role in the country where its fund manager is investing or could not do so due to unforeseeable external events.[51]

14. Delegation

The Commission and Parliament's proposals indicate that any delegation by a manager would require prior approval by its regulator. However, Parliament proposes that regulators may within one month reject such delegation. The Council relaxes the delegation requirements so that a manager only has to notify its regulator rather than to seek approval in advance of a delegation.

Under each proposal, the manager's liability would not be affected by any such delegation and a manager would not be able to delegate to the extent that it ends up no longer being the manager of the fund. The Commission and Parliament propose that authorized managers would only be able to delegate management functions to other EU authorized managers.[52] This differs from the Compromise Proposal which would allow an AIFM to delegate management functions to other non-EU managers provided that those other managers are "registered for the purposes of asset management."

Parliament includes the further requirement that AIFMs shall inform investors which functions have been delegated and to whom. Portfolio management, risk management or liquidity management may only be delegated to AIFM authorized to manage funds of the same type.[53]

15. Capital requirements

Each of the proposals stipulate that managers will be required to hold and retain a minimum level of capital of at least €125,000, plus 0.02% of the amount by which the value of the manager's portfolios exceeds €250 million.[54]

firm that acts as depositary as part of its professional or business activities and is subject to mandatory professional registration requirements.

48 Council Compromise Proposal Article 6(4b).

49 Parliament's Proposal Article 17(3a).

50 Parliament's Proposal Article 17(4).

51 Parliament's Proposal 17(5a).

52 Proposed Directive Article 18.

53 Parliament's Proposal Article 18(1)(b).

54 Proposed Directive Article 14.

The Compromise Proposal and Parliament's Proposal additionally specify that (i) the maximum capital requirement for any authorized manager would be €10 million; (ii) any self-managed fund must be subject to an initial capital requirement of at least €300,000; and (iii) fund managers may be exempt from up to 50% of the extra capital required if they have guarantees by a bank or an insurance company matching the amount by which they are to be exempt.[55] Unlike the Parliament's Proposal which exempts private equity funds from capital requirements, the Council's Compromise Proposal states that smaller private equity fund managers who choose to "opt in" to the Proposed Directive would be subject to an initial capital requirement of at least €50,000.[56]

16. Disclosures to investors

Under each of the proposals, investors must be provided with a considerable amount of information (some of which will already be provided by managers in offering documentation as a matter of course), including a description of the fund's objectives and investment strategy, assets in which the fund may invest, investment restrictions, delegation of functions and any conflicts of interests arising as a result, details of the circumstances in which leverage may be used, the types and sources of leverage permitted and any associated risks or restrictions.

The Compromise Proposal and Parliament's Proposal also stipulate that the identity of the entity to which functions are delegated and the liability regime between the external valuer, the manager and the investors should be disclosed.[57] The Parliament's Proposal further requires that information on the domicile of underlying funds (in the case of fund of funds), the domicile of any master fund (in the case of feeder funds) and a description of the past performance of the fund be provided.

[55] Parliament's Proposals Article 14(4b) and (4c).

[56] Council Compromise Proposal Article 6a(3).

[57] Council Compromise Proposal Article 20 and Parliament's Proposal Article 20.

Each of the proposals includes the requirement that details of preferential treatment of particular investors in side letter arrangements should be disclosed to other investors. Only the Council's proposal suggests that the identity of any investor receiving that preferential treatment should not be disclosed.[58]

17. Reporting to regulatory authorities

Proposed Directive: In addition to an annual financial report, information to be reported regularly to regulators includes: (i) the main markets and instruments in which the manager trades; (ii) the principal exposures of the manager's funds; (iii) the percentage of any fund's assets that are illiquid; (iv) the main categories of assets in which any fund is invested; and (v) any use of short selling.[59]

Compromise Proposal: The Council broadly retains all of the Commission's proposals, except in one important respect: rather than requiring regular reporting, the Council suggests that such reporting will generally only be required on request by regulators. The Council clarifies that the list of information to be reported is non-exhaustive, so as to enable regulators to require more information on a periodic and *ad hoc* basis if deemed necessary for the purposes of monitoring systemic risk.

However, information relating to the use of leverage by fund managers will still have to be made available to regulators. Specifically, as regards short selling, the Council also states that regulators should share information relating to short selling with each other, CESR (or ESMA) and the proposed new European Systemic Risk Board ("ESRB").

Parliament's Proposal: The Parliament broadly retains the Commission's original proposals. Regulators would need to be informed about the overall leverage used for each fund, the way fees are paid and the amounts paid to the fund manager, as well as performance data of the fund including the valuation of its assets.[60]

[58] Parliament's Proposal Article 20(i).

[59] Proposed Directive Article 21.

[60] Parliament's Proposal Article 21(ca).

Regulators may ask for additional information from managers which they consider may pose systemic risk. ESMA and ESRB may also require additional reporting in exceptional circumstances or in order to protect the stability of the financial system.[61]

Managers would be required to disclose information on significant short positions to regulators, who may request reporting on all short positions and securities borrowed if necessary.[62] Parliament's Proposal suggests that legislation should be amended to ban naked short selling across the EU.[63]

18. Leverage (and limits on leverage)

Proposed Directive: The threshold for imposing additional obligations on managers for the use of leverage is when a fund "employs leverage on a systematic basis".[64]

When a fund employs leverage on a systematic basis the manager must periodically disclose to investors the amount of leverage used and the maximum level of leverage that can be employed on behalf of the fund.[65] The manager must also disclose to its regulators the overall level of leverage, a breakdown between leverage arising from the borrowing of cash or securities and leverage embedded within derivative instruments, the five largest sources of debt or securities and the amount of leverage received from those sources.[66]

Leverage limits would be imposed in two ways: first, the Commission would adopt implementing measures setting blanket leverage limits for different types of fund, and second, Member States would be able to impose temporary leverage limits in exceptional circumstances.[67]

Compromise Proposal: The Council does not propose to amend the disclosure requirements in relation to the use of leverage.

However, in relation to leverage limits, the Council removes the idea that the Commission should impose blanket leverage limits for different types of funds in all market conditions. The ability of Member States to impose leverage limits in exceptional circumstances is retained. Indeed, the Council extends Member States' powers by providing that, in addition to leverage limits, "other restrictions" could also be placed on managers in such circumstances. The rationale for the possible imposition of other restrictions is "to limit the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system or risks of disorderly markets".[68] This amounts to a remarkably broad and undefined power, although it is suggested that the Commission will adopt implementing measures that clarify when this power might be used.

Parliament's Proposal: The Parliament rejects the idea that the Commission should adopt blanket leverage limits for different types of fund. The Parliament's Proposal proposes that fund managers should be able to set their own leverage limits in respect of each fund that they manage. Regulators would then monitor the suitability of these limits. ESMA would also have the power to require these limits to be corrected if it considers them inappropriate.[69]

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61 Parliament's Proposal Article 21(2a) and (2b).

62 Parliament's Proposal Article 11(ba).

63 Parliament's Proposal Recital (16a). The European Commission published its consultation paper on short selling on June 14, 2010. The Commission effectively proposes banning naked short selling by requiring any person who enters into a short sale of any share to have either borrowed the share, have entered into an agreement to borrow the share or has evidence of other arrangements which ensure he will be able to borrow the share at the time of settlement. Responses to the consultation are due by July 9, 2010.

64 Proposed Directive Article 22.

65 Proposed Directive Article 23.

66 Proposed Directive Article 24.

67 Proposed Directive Article 25.

68 Council Compromise Proposal Article 25(3a).

69 Parliament's Proposal Article 25.

19. Controlling influence disclosure

These additional obligations are likely to be of particular relevance for private equity funds.

Proposed Directive: The Commission proposes that where a manager is in a position to exercise 30% or more of the voting rights of an issuer or non-listed company domiciled in the Community the manager would be required to: (i) notify the company and its shareholders of this; and (ii) provide them all with related information, including as to voting rights, the conditions under which the 30% threshold has been reached and the date on which it was reached or exceeded.[70]

The provisions would not apply to small or medium-sized enterprise.[71]

The manager would also be required to make certain disclosures to shareholders and their employees (or representatives thereof).[72]

Compromise Proposal: The Council proposes that the threshold at which the notification requirements are triggered should be increased from 30% to 50% of voting rights. The disclosure requirements would not apply if the target company fulfils two or more of the following conditions: (i) it employs fewer than 250 persons; (ii) it has an annual turnover not exceeding €50 million; and (iii) its annual balance sheet total does not exceed €43 million. The disclosure requirements would also not apply to non-listed special purpose vehicles that have been established with the purpose of purchasing, holding or administering real estate.

The Council proposes that the manager inform the investors and its regulator of the debt supported by the non-listed company or issuer (with which the manager is in a position of control) before and after the acquisition and whenever "material changes" occur.[73]

Parliament's Proposal: The Parliament introduces more onerous requirements in relation to disclosure of a controlling influence in non-listed companies. The Parliament's Proposal proposes that a fund manager acquiring 10, 20, 30 and 50% of the voting rights, either directly or indirectly, of an EU non-listed company must notify regulators, the investors in the relevant fund and the employee representatives of the non-listed company within five working days.[74]

The fund manager must also provide information on the communication policy with employees, plans for conflict-resolution and indicate which persons are responsible for deciding on business strategy and employment policy. Fund managers must give notice to investors of any planned divestment of assets.[75]

Parliament has also proposed rules to prevent perceived asset stripping by some private equity funds. A company owned by private equity must have capital which is in line with the requirements on capital adequacy established in existing EU legislation (the Capital Adequacy Directive).[76]

These proposals will not apply where the non-listed company concerned (including subsidiaries) employs less than 50 persons. These requirements will continue to apply for one year from the date a listed company which has been acquired by a private equity fund withdraws from the regulated market.[77]

Credit Rating Agency Regulation

The European Commission recently published a proposal to amend the Credit Rating Agency Regulation (the "Regulation"). One of the proposed amendments would add alternative investment funds to the list of entities required to only use credit ratings for regulatory purposes which have been issued by credit rating agencies registered or certified under the Regulation.[78]

70 Proposed Directive Articles 26 and 27.

71 Proposed Directive Article 26(2).

72 Proposed Directive Article 28.

73 Council Compromise Proposal Article 28a.

74 Parliament's Proposal Article 26(1).

75 Parliament's Proposal Article 28.

76 Parliament's Proposal Article 27.

77 Parliament's Proposal Article 30.

78 Proposal to amend the Regulation Article 1.

Under the amended Regulation credit ratings agencies would be required to be registered with and become certified by ESMA. Credit ratings produced by third-country credit ratings agencies would only be used if ESMA is satisfied that the third country credit ratings agency complies with requirements of the Regulation. National regulators would continue to monitor funds' compliance with the Regulation.

The Commission aims for the amendment to the Regulation to come into force in 2011 prior to the AIFM Directive coming into force albeit the funds subject to the amended Regulation would be those described as alternative investment funds in the Proposed Directive. This timeframe will be subject to ESMA being able to take on the required supervisory and registration functions.

Commentary

Although the Compromise Proposal and the Parliament's Proposal reflect the positions of the Council and Parliament on the Proposed Directive, the final text may incorporate different aspects of each proposal. As such, the form of the final text remains uncertain until it is agreed between the Commission, Council and Parliament and voted on in Parliament on July 6, 2010 (indicative date).

There are significant provisions of the Proposed Directive which remain subject to widespread disagreement. The "Issue Note" published by the Council to accompany its Compromise Proposal identified that Member States such as the UK, Czech Republic, France and Ireland had reservations on parts of the text relating to third-country issues, depositary arrangements, remuneration, disclosure and valuation.[79]

The main cause for concern is restrictions on the marketing by a non-EU fund to professional investors in the EU which would only allow such marketing on the basis of the EU and third country entering into "appropriate arrangements in line with international standards."[80] Such equivalence arrangements would have to be assessed by the European Commission and it is feared this could take considerable time and propagate global uncertainty among the alternative fund industry. AIMA has warned that the current third-country provisions would restrict the product range available for investment in the EU and, for the EU professional investor, the selection of "the best in class" would no longer be relevant.

Private equity funds acquiring non-listed companies will under each proposal become subject to notification and reporting requirements. The Parliament's Proposal sets out the most stringent requirements. However, Parliament also includes a partial exemption for private equity funds from the risk and liquidity management, capital and depositary requirements under the Proposed Directive.

It is likely that the remaining contentious provisions will continue to be fiercely debated and will be subject to intense lobbying from the industry, Member States and non-EU countries with significant interests in the European AIF market such as the US

[79] See http://register.consilium.europa.eu/pdf/en/10/st07/st07378.en10.pdf.

[80] Council Compromise Proposal Article 34b.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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