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A new regulatory landscape for alternative investment and non-UCITS in Europe – but in what form?

Introduction

The financial crisis has resulted in an inevitable regulatory backlash as policymakers across the globe move to address the failings of the current system and, in part, to punish those perceived to have caused the greatest damage. While many of these initiatives have been welcomed, some feel the current political agenda has overstepped the mark and is pushing overly burdensome regulation into areas where there are existing adequate controls, where no evidence of proportionate fault has been demonstrated[1] and at a time where the markets can least afford the accompanying legal and compliance costs.

One such controversial measure is the European Commission's proposal for a Directive[2] to establish a harmonised EU framework for the authorisation and operation of alternative investment fund managers (AIFM). The Directive itself has come as little surprise to readers familiar with the background to proposed global alternative investment reforms. The Commission had, albeit during an extremely short consultation period, clearly flagged its intention to propose regulation and hedge funds and private equity were also identified in some circles as major contributors to problems in the current financial system. However, the industry itself felt this position had been taken in haste without sufficient analysis and that it was clear that the most serious cause of current difficulty stems, not from lightly regulated hedge funds or private equity vehicles but from the heavily regulated banking and insurance sectors. As a result, the debate was heated on both sides of the argument and the publication of the proposed Directive has only fuelled these fires.

The Directive would radically alter the manner in which AIFM operate in Europe. The Commission estimates that roughly 30 per cent of hedge fund managers, managing almost 90 per cent of assets of EU domiciled hedge funds, would be covered by the Directive. It would capture almost half of managers of other non-UCITS funds and provide an almost full coverage of the assets invested in their funds. In this regard, it will impose significant requirements in terms of AIFM capital, internal organisation, the manner in which they organise their alternative investment funds (AIF), their responsibility for the management of the AIF, the conditions under which they can delegate their activities. It also includes significant requirements as regards valuations, 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 would have an impact not only on hedge funds and private equity funds, which it clearly targets, 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.

On the positive side, the Directive will harmonise requirements across the EU, create a clear set of investor protection rules and provide a UCITS style EU marketing passport, allowing authorised AIFM to sell AIF on a cross-border basis within the EU to professional investors and possibly to retail investors.

This article seeks to consider the main arguments and to addresses the key features and current ambiguities in the Directive.

Current position pre-Directive

AIFs, AIFMs and other service providers

Currently, the activities of managers, investment managers, most valuators and depositories and some AIF established in the European Community are regulated by a combination of national financial law regulations and general provisions of

Community law. While this system has worked to date permitting: (i) the rapid growth of some member states, for example, Ireland and Luxembourg, as AIF domiciles to rival traditional offshore locations; and (ii) other member states, particularly the UK, to rival the US as a centre for AIFM; there are gaps in the framework. The proposed Directive is intended to overcome these gaps and to provide a basis for the development of an internal market.

Investment managers established within 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 Directive 2004/39EC (MiFID). Article 2(1)(h) of 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. 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.

AIFs have no pan-European set of legislation but rather are regulated according to the domestic law of their domicile, e.g. the regulation of Irish AIFs under Part XIII of the Companies Act, 1990, the Unit Trust Act, 1990, the Investment Limited Partnership Act, 1995, the Limited Partnership Act, 1907 and various other domestic company, trust, common contractual fund, tax laws and even UCITS Regulations (to cover sophisticated mutual funds employing hedge fund-like techniques).

Marketing and private placement rules

AIFs are currently sold within the European Community under a patch-work of national private placement rules.[3] Some member states have clear laws, others rely on regulatory guidance or distribution through licensed intermediaries and others provide an outright prohibition without local registration or rely on 'reverse solicitation' principles which are not wholly satisfactory.

Self-regulation and industry codes

The national rules and general provisions are supplemented in some areas by industry-developed standards. Numerous different AIF initiatives and organisations such IOSCO, IMF, OECD and industry bodies, such as IFIA, AIMA, MFA, the Hedge Fund Standards Board and the Presidents Work Group on Financial Markets, have established principles and codes of best practice over the past few years.

Scope of the proposed Directive

Pursuant to Article 2, the Directive would apply to any natural or legal 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 its domicile or 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.

There are a number of entities who might otherwise be subject to the Directive but are exempt under Article 2(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, or €500 million when the funds are unleveraged with no redemption rights exercisable during a period of five 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 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;[4] and (vii) Supranational institutions, such as the World

Bank, the IMF, the ECB, the EIB, the EIF and similar organisations.

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.

Which categories of AIFM are subject to the Directive?

While the overall intention of the Directive to regulate AIFM is clear there are several technical and drafting ambiguities in the proposal which will need to be clarified.

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 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 European Community marketing non-UCITS domiciled outside of the Community into the Community

If an AIFM established outside of the Community wished to manage and market a non-Community AIF 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, which is considered further below). 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' within the meaning of the Directive is 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 (ie, 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. One of the stated premises of the Directive[5] 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 AIFs 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 AIFs

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 Explanatory Memorandum that accompanied the proposed 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 (depositary bank where relevant and valuation entity).

Marketing and permitted categories of investors

In summary, the Directive would permit AIFM to market AIF on a cross-border basis within the European Community to mainly professional investors on a prior notification basis but without the need for separate authorisations in each member state. However, it will impose significant restrictions on selling into Europe from outside the Community; will affect the current private placement regime and the existing limited retail alternative market, for example for open-ended real estate funds or funds of hedge funds.

What constitutes marketing?

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'.

Who are professional investors?

The concept of 'professional investor' has been linked to the professional client standards set out in Annex II of MiFID which will be familiar to most AIFM, that is investors who possess the experience, knowledge and expertise to make their own investment decisions and properly assess the risks that it incurs. This overall standard is further restricted to sophisticated regulated, large cap and institutional investors and governments or national bodies.

Marketing AIFs within the Community to retail investors

The Directive authorises 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.

Marketing AIFs 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 (the 'home member state') under Article 39, can market shares of AIF to professional investors 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.

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.

Marketing AIFs into member states other than the AIFM's home member state

Authorised AIFM can market AIFs that they manage to professional investors in a member state other than the one in which the AIFM is authorised provided that it submits prescribed documentation to the competent authority of its home member state.

AIFM established outside the European Community – authorisation to market AIFs 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.

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.

The authorisation process for AIFMs

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 per cent 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 (vi) 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 fulfil 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 (the 'home member state') to provide management services to AIF domiciled in another member state (the 'host 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 prescribed information to the home member state regulator. The host member states are not permitted to impose any additional requirements on the AIFM in respect of matters covered by the Directive.

Operating conditions for AIFM

The Directive also prescribes a number of broad conduct of business requirements for AIFM such as: (i) 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; (ii) 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; (iii) 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 (iv) 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 per cent 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.

AIFM 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; and (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.

Valuators

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 AIF 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 realisation 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 to delegate 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.

Depositary bank

The Directive would also introduce radical rules regarding the appointment and liability of depositary 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 depositary (that is, 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 depositary or its sub-depositaries.

The proposal provides that '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' and that liability can be invoked either directly or indirectly through the AIFM depending on the legal nature of the relationship between the depositary, the AIFM and the investors.

The depositary 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 'depositary'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 depositary may delegate its depositary tasks to a sub-depositary 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.

Irish rules require the appointment of an independent Depository but this is not always common to traditional offshore AIF models. 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 AIF custody their assets with 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, branches of EU credit institutions, 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 the foregoing and providing 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 AIF 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. In contrast, Article 16 of the UCITS Directive (applying to retail mutual funds) 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. Further, a UCITS 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.[6]

Transparency requirements for AIFMs

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: (i) 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; (ii) 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; (iii) a description of any delegated management or depositary function and the identity of the third party to whom the function has been delegated; (iv) 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 (v) a description of all fees, charges and expenses.

Certain specific disclosures required by the Directive might not be typically disclosed, including the following: (i) the types and sources of leverage permitted; (ii) a description of any legal instruments providing for the recognition and enforcement of judgments on the territory where the AIF is domiciled; (iii) 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 (iv) 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: (i) 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; (ii) any new arrangements for managing the liquidity of the AIF; and (iii) 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: (i) 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; (ii) the percentage of the AIF's assets that are subject to 'special arrangements' arising from their illiquid nature; (iii) any new arrangements for managing the liquidity of the fund; (iv) the current risk profile of the AIF and the risk management systems used; (v) the main categories of assets in which the AIF invested; (vi) where relevant, the use of short selling during the reporting period; and (vii) 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

AIF with controlling influence in companies

Where AIFs managed by an AIFM take significant stakes (over 30 per cent 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 per cent of the voting rights. The specific headings for the notification are set out in the Directive.

What next? [7]

The Directive forms parts of a larger series of reforms and proposal from the Commission in response to the financial crisis. These include capital adequacy, OTC derivatives, credit rating agency and securities reforms.

This Directive is a so-called 'Lamfalussy' Directive. Under the Lamfalussy process, Parliament and Council will now seek to adopt the Directive under the co-decision procedure. This is known as 'Level 1' in the Lamfalussy process. 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 and 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.

However, it is not yet certain that the Directive will get to this stage without further amendment. As previously noted, 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.

Individual member states are also divided and, while it is perhaps overly simplifying national positions into broad categories: (i) a majority in Ireland, the UK and Sweden (who currently hold the European Presidency) among others coming have come out strongly in favour of amendment to the Directive; while (ii) high profile ministers and officials in other member states, like Germany and France, have lent their support to the reforms as currently drafted or have called for even stricter measures.

Bodies such as AIMA are currently mobilising the industry in order to present these and other arguments to the relevant institutions in Europe. These efforts would appear to be gaining traction and greater measures of support. However, it is also interesting to note that there were many politically controversial provisions in the MiFID Directive at Level 1, yet in the end that Directive was eventually implemented under the co-decision procedure without much fuss.

Finally, the Directive has attracted considerable interest outside of Europe, particularly in the US as one of the world's largest centres for AIFM activity. The US is also considering its own reforms and on 15 July 2009 the Obama Administration delivered the latest legislative proposal. The proposal is aimed at advisers of hedge funds and other private pools of capital, including private equity and venture capital funds and, if passed, would: (i) require most previously unregistered investment advisers to register with the Securities and Exchange Commission (SEC); and (ii) require all registered investment advisers to comply with new reporting and recordkeeping requirements and provide information about private funds which they manage, including assets under management, use of leverage, counterparty credit risk exposures, trading and investment positions and trading practices. Advisers with more than $30 million in AUM would have to register under the Investment Advisers Act, 1940 and become subject to compliance with that Act. An exemption would be available for certain foreign private investment advisers with limited US clients. The accompanying press release from the Administration sets out some of the rationale behind the move and notes that, at various points in the financial crisis, de-leveraging by such funds contributed to the strain on financial markets. As these funds are currently not required to register with regulators, the Administration feels that the US Government lacked the reliable, comprehensive data necessary to monitor funds' activity and assess potential risks in the market. The aim of the legislation is therefore, to help protect investors from fraud and abuse, provide increased transparency and provide the information necessary to assess whether risks in the aggregate or risks in any particular fund pose a threat to our overall financial stability.

The danger of two of the world's largest AIFM centres proposing independent and contrasting reforms has been well documented and the final positions will be of great interest to lawyers working in the area. Global agreement on investment fund issues is extremely rare and it should be noted that the European and US industries have functioned on very different regulatory platforms to date in a manner which had seen tremendous growth prior to the current financial crisis. However, the new proposals have been described in some quarters as protectionist and, if implemented in their current form, have the potential to fragment the global alternatives industry in a manner not seen previously.

Notes

1 De Larosière Group Report states that: '*Concerning hedge funds, the Group considers they did not play a major role in the emergence of the crisis. Their role has largely been limited to a transmission function, notably through massive selling of shares and short-selling transactions. We should also recognise that in the EU, unlike the US, the great bulk of hedge fund managers are registered and subject to information requirements.*'
2 Proposal for a Directive of the European Council and of the Parliament on Alternative Investment Fund Managers.
3 The unsatisfactory nature of the existing regime has been previously addressed the Commission, eg, Commission Staff Working Document – Impact Assessment Report on Private Placement {SEC(2008) 2341}. These early reports were unable to reach a consensus and now appear likely to be overtaken by the proposed marketing rules in the Directive.
4 Covered by Directive 73/239/EEC, Directive 2002/83/EC and Directive 2005/68/EC respectively.
5 See the Commission's Impact Assessment which accompanied the Directive (COM (2009) 207, SEC(2009) 577).
6 Working document of the Commission Services (DG Markt) – Consultation Paper on the UCITS Depository Function.
7 Further information on the proposed Directive, updated commentary and Irish and EU developments can be obtained from the author or at **http://www.dilloneustace.ie/publications**.
8 **http://www.treasury.gov/press/releases/tg214.htm**.