

## EU Directive on Alternative Investment Fund Managers: ECON Committee and Council Drafts Adopted

On May 17, 2010, the European Parliament's Economic and Monetary Affairs Committee ("ECON") adopted proposed amendments (the "ECON Version")<sup>1</sup> to the European Commission's draft (the "Commission Proposal") Directive on Alternative Investment Fund Managers (the "AIFM Directive").<sup>2</sup> The AIFM Directive will regulate managers ("AIFMs") of "alternative investment funds" ("AIFs"), in particular hedge funds and private equity funds. Registered AIFMs will have the right to market certain AIF interests in all EU Member States (the "EU passport").

The Council of Ministers (the "Council") adopted its proposed version (the "Council Version")<sup>3</sup> of the AIFM Directive on May 18, 2010, setting the stage for so-called "trialogue" negotiations between the European Parliament (the "Parliament"), the Council and the European Commission (the "Commission") to agree on a harmonized text. The Council and the Parliament aim to adopt the AIFM Directive in July 2010, but adoption may slip into the second half of 2010.

This Memorandum summarizes the principle elements of the ECON Version and the Council Version and compares them to the Commission Proposal, which they have now superseded.

### **I. BACKGROUND**

The Commission Proposal was drafted and published very quickly and in a heavily politicized climate, without the usual period of consultation and review. It was widely criticized, in particular for imposing unnecessary and onerous burdens on AIFMs and AIFs and for its one-size-fits-all approach to AIFMs managing different types of AIFs.

The AIFM Directive will be adopted under the EU's so-called "co-decision procedure," under which the Commission proposes a draft law, but the law is actually adopted by the Parliament and the Council. The Council consists of a government

<sup>1</sup> 2009/0064(COD) (<http://tinyurl.com/ECONVersion>)

<sup>2</sup> COM(2009)0207 (<http://tinyurl.com/CommissionProposal>)

<sup>3</sup> 7500/10 (Presse 64) (<http://tinyurl.com/CouncilVersion>)

minister from each Member State and meets in different compositions depending on the policy area being addressed. The Council has a rotating Presidency, which presides over working groups that review the Commission's draft laws in parallel with the relevant Parliament committees.

The Swedish Presidency ran from July to December 2009 and published several revised drafts of the AIFM Directive, but it was unable to achieve the qualified majority required for adoption. The current Spanish Presidency also published several drafts and by March 2010 had assembled the qualified majority necessary to approve its proposal. The Spanish Presidency postponed adoption of the Council Version at the request of Gordon Brown, however, bringing the proposal to a vote only after the May UK elections. The Spanish Presidency will end in June 2010 and will be followed by the Belgian Presidency, which will last until the end of 2010.

In the Parliament, ECON is the lead committee responsible for reviewing the Commission Proposal. Before adopting its compromise amendments on May 17, ECON published approximately 1,700 proposed amendments submitted by Members of Parliament. In addition, ECON received an opinion of the Parliament's Legal Affairs committee, known as JURI, on April 28, 2010<sup>4</sup>.

## **II. SCOPE**

Under all three versions, the AIFM Directive applies to AIFMs established in the EU, regardless of the domicile or legal structure of the AIFs they manage. However, there are significant differences in scope between the Commission Proposal, the Council Version and the ECON Version.

Under the Commission Proposal, the AIFM Directive would not apply (among other exemptions) to (i) EU AIFMs that neither manage EU-domiciled AIFs nor market AIFs within the EU, (ii) AIFMs whose assets do not exceed EUR 100 million (or EUR 500 million in the case of private equity funds) (the "*de minimis* exemption"), and (iii) certain other types of AIFs.

Under the Council and ECON Versions, EU-based AIFMs that do not manage or market AIFs in the EU would not be exempt from the AIFM Directive. Under the Council Version, each Member State could decide whether to apply the *de minimis* exemption; the ECON Version would preserve the *de minimis* exemption as to parts (not all) of the AIFM Directive, but lower the threshold for private equity funds to EUR 250 million.

The Council and ECON Versions add a number of new exemptions. Under the Council Version, corporate group finance companies, employee participation or saving

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<sup>4</sup> 2009/0064(COD) (<http://tinyurl.com/JURIopinion>)

schemes and securitization special purpose entities would be exempt. Under the ECON Version, AIFMs would be exempt from parts (not all) of the AIFM Directive in respect of corporate group finance companies, AIFs with three or fewer professional investors, real estate AIFs and private equity AIFs. Private equity AIFs are defined as AIFs “whose investment policy is to invest in equity and equity-related securities of, principally, private companies and businesses in order to finance venture capital, growth plans and buyouts.”

### **III. OPERATING CONDITIONS**

The AIFM Directive would impose stringent requirements on the operations of AIFMs, including requiring the appointment of independent “valuators” and “depositories” and limiting investments in securitization positions. The nature and extent of these requirements varies considerably under the Commission Proposal, the Council Version and the ECON Version. In general, the Council Version and the ECON Version address criticism that the Commission Proposal’s one-size-fits-all approach would result in unnecessary and onerous burdens being imposed on AIFMs managing certain types of AIFs. On the other hand, both versions introduce requirements not contemplated in the Commission Proposal, notably with respect to remuneration.

#### **1. Remuneration**

The Commission Proposal did not address the remuneration paid by AIFs or AIFMs, but remuneration paid to financial sector employees has since become a sensitive political issue. As a result, both the Council Version and the ECON Version include extensive provisions dealing with remuneration.

Under the Council Version, AIFMs would be required to have remuneration policies and practices for staff whose professional activities materially impact the risk profiles of the AIFs under management, and such policies and practices would be required to “take into account” a list of principles similar to those imposed on systemically important banks under the Capital Adequacy Directive. The ECON Version would require AIFMs’ remuneration policies to be “compatible” with those applicable to credit institutions and investment firms. In practice, this is likely to result in the application of guidelines that are similar to those set out in the Council Version. AIFMs would be required to disclose the aggregate remuneration paid in their annual reports, broken down by fixed and variable remuneration and, where relevant, by AIF.

#### **2. Valuators**

The Commission Proposal required AIFMs to appoint an independent valuator, which would value AIF assets at least annually, for each AIF under management. The independent valuator would have to apply certain standards set out in the Commission Proposal, and if established in a country outside the EU, that third country would have to

be deemed by the relevant Member State to have valuation standards equivalent to those applicable in the EU.

The Council Version would make the appointment of an independent valuator optional. AIFMs would be required to ensure that each AIF under management has appropriate and consistent procedures in place so that proper valuations of assets can be performed at least on an annual basis. AIFMs would also have to ensure that the valuation function is independent, subject to a proportionality test unless the AIFMs compensation is linked to performance. When the valuation function is not independent, Member States may require valuations to be externally verified.

The ECON Version would require the appointment of a valuator that is “legally or functionally” independent of the AIFM. The AIFM would be responsible for ensuring that independence is embedded into the processes adopted for valuations and that safeguards are in place to prevent conflicts of interest arising. The ECON Version makes these requirements optional for private equity and real estate AIFs.

### **3. Depositaries**

The Commission Proposal required AIFMs to appoint an EU-based credit institution for each AIF under management to act as an independent depositary. The depositary would have to receive payments from investors and keep them in a segregated account, safe-keep the AIF’s financial instruments and verify the ownership of all other assets the AIF invests in. The depositary would be strictly liable to AIF investors for losses suffered as a result of its failure to perform its obligations.

The Council Version and the ECON Version would allow a wider range of institutions to act as depositary and would allow some limitations of liability by contract or for *force majeure*. On the other hand, both versions would impose additional requirements not contemplated by the Commission Proposal, including a requirement that depositaries verify that AIFs comply with national law and with their instruments of incorporation when issuing shares and units. The ECON Version exempts AIFMs from depositary requirements with respect to private equity and real estate AIFs.

### **4. Capital Requirements**

Under the Commission Proposal, an AIFM would have to have own funds of at least EUR 125,000 plus 0.02% of the amount by which the value of the portfolio of the AIFM exceeds EUR 250 million.

The Commission Proposal’s capital requirements were criticized among other things for failing to distinguish between the capital needs of closed-ended funds, whose investors do not have redemption rights, and other types of funds. Under both the Council Version and the ECON Version, the additional own funds requirement would be

capped at EUR 10 million. In addition, under the Council Version private-equity AIFMs whose total assets do not exceed EUR 500 million would need to have only EUR 50,000 of initial capital. The ECON Version goes even further, exempting private equity from the capital requirements of the AIFM Directive.

#### **IV. DISCLOSURE REQUIREMENTS**

Under the Commission Proposal, AIFMs would have to disclose information to investors both before they invest and on an ongoing basis thereafter. Matters to be disclosed include investment strategy, valuation procedure, liquidity risk management and arrangements under which any investors receive preferential treatment. AIFMs' annual reports would be required to include audited accounts in compliance with EU law for each AIF they manage.

As noted, the Council and ECON Versions both add new disclosure requirements relating to remuneration. The ECON Version also provides that the annual financial reports of non-EU AIFs may be audited in accordance with "international accounting standards" in force in their countries of establishment (not necessarily EU law).

The Commission Proposal also included supplemental disclosure requirements for AIFM managing leveraged AIFs and those managing AIFs that acquire a "controlling influence" (defined as an interest of 30% or more) in EU companies – in practice, private equity portfolio companies. AIFMs managing AIFs employing "high levels of leverage on a systematic basis" would have to disclose to investors and regulators (among other things) the maximum leverage levels that can be employed and certain information about their positions. AIFMs acquiring a controlling influence in EU companies would have to make certain disclosures to the company, its other shareholders, and employee representatives, including in the case of non-listed companies the AIF's "development plan." AIFs would also have to provide additional information in their annual reports and to employee representatives, including financial information, information on employee matters and a statement on significant divestments of assets. Public companies taken private after being acquired by an AIF would have to continue making public company disclosures for two years.

The Council and ECON Versions take very different approaches to the supplemental requirements set out in Chapter V of the Commission Proposal. The Council Version would delete the special disclosure requirements for AIFs employing "high levels of leverage on a systematic basis," and revise the threshold triggering the supplemental disclosure requirements for private equity portfolio companies from 30% to 50%. The Council Version would also scale back the more onerous disclosure requirements; eliminate the requirement for AIFMs to make disclosure directly to portfolio company employee representatives; and delete the requirement to continue making public company disclosure for issuers that are delisted after acquisition by an AIF.

In contrast to the Council Version, the ECON Version would make generally make the Commission Proposal requirements for portfolio company disclosure more onerous rather than less. An AIFM would have to notify a company, its other shareholders and its employee representatives not only upon acquiring controlling influence, but each time the AIFM passes a 10%, 20%, 30% or 50% threshold. The ECON Version would extend to all private equity portfolio companies the capital adequacy regime currently applicable under EU law to public limited companies. AIFMs would have to include additional information in their annual reports and to employee representatives, including regarding research and development efforts, employment matters, management compensation, and changes to places of business. AIFMs would have to continue to make public company disclosures regarding portfolio companies that are taken private, though for one year rather than two (as under the Commission Proposal). Onerous as the ECON Version would be in this area, a number of members apparently pushed for even more stringent obligations.

## **V. LEVERAGE**

The Commission Proposal required the Commission to adopt binding leverage limits on AIFs. This provision was criticized as unduly rigid and potentially counterproductive in an industry with a wide variety of business models.

The Council Version and the ECON Version differ significantly in their treatment of leverage. The Council Version would allow Member States (not the Commission) to impose leverage limits, but only in emergencies. The ECON Version would require AIFMs to adopt their own leverage limits, which could take into account the type of AIF, its strategy and other factors, though these limits would be reviewed by the AIFM's home regulator (based on guidelines to be adopted by the Commission) to ensure that the leverage limits set by the AIFM are reasonable.

## **VI. MARKETING OF EU AIF INTERESTS**

Under the Commission Proposal, authorized AIFMs could market interests in EU-based AIFs to professional investors<sup>5</sup> in their home Member State after notifying the competent authorities, which may impose restrictions or conditions. Once the competent authorities in the AIFM's home Member State have granted marketing permission, the AIFM would have the right to market AIF interests in other Member States under the EU passport, subject to compliance with a similar notice procedure. Member State authorities could allow marketing of AIFs to retail investors within their own territories and may impose additional requirements in respect of such marketing.

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<sup>5</sup> "Professional investors" are defined by reference to the MiFID definition of "professional client," which includes institutional and large corporate investors, as well as certain other persons (including individuals) who may "opt in" if they meet certain tests.

The Council Version streamlines the EU passport mechanism and would provide that any additional requirements for marketing to retail investors may not discriminate against cross-border marketing. It would also reinforce the EU passport by making clear that the competent authorities in a host Member State can only prevent marketing of interests in EU AIFs by authorized AIFMs where the information provided in the notification demonstrates that the AIF concerned will not be managed in accordance with the AIFM Directive. The Council Version would, however, exclude from the EU passport “feeder AIFs,” defined as AIFs that invest 85% or more of their assets in another AIF (*i.e.*, the “master AIF”) that would not themselves qualify for the EU passport, or in more than one such master AIF where those master AIFs have “identical investment strategies.”

The ECON Version follows the Commission Proposal with respect to the marketing by AIFMs of interests in EU-based AIFs, but also applies the same approach to the marketing of non-EU-based AIFs (see below).

## **VII. MARKETING OF NON-EU AIF INTERESTS**

Under the Commission Proposal, authorized AIFMs would be allowed to market interests in non-EU AIFs only three years after the deadline for implementation of the AIFM Directive. At the end of that period, authorized AIFMs could market interests in non-EU AIFs in any Member State under the EU passport, provided that the AIF’s home country has signed an agreement with the investor’s Member State complying with Article 26 of the OECD Model Tax Convention and ensuring an effective exchange of information on tax matters.

The Council Version does not contain any limitation on AIFMs marketing non-EU AIF interests to the extent permitted under applicable Member State law, but when marketing non-EU AIF interests AIFMs (whether established in the EU or not) would not benefit from the EU passport. Under the Council Version, moreover, EU AIFMs could manage non-EU AIFs only if the AIFs’ home countries are compliant with “the standards set by international organizations” with respect to “relevant legislation” and whose home-country supervisory authorities have entered into “appropriate cooperation arrangements” with the competent authorities.

The ECON Version would allow authorized AIFMs to market interests in non-EU AIFs to the extent permitted under applicable Member State law, but without the benefit of the EU passport. The ECON Version would however prohibit EU-domiciled professional investors from investing in non-EU AIF interests unless the relevant AIF is managed by an EU-based AIFM or based in a third country that has “signed an information-sharing cooperation agreement in line with relevant international standards.”

### **VIII. AUTHORIZATION OF NON-EU AIFMS**

The Commission Proposal set out a procedure under which the competent authorities in a Member State could authorize a non-EU-based AIFM to market AIF interests to professional investors in the EU if, among other things, the Commission determined that the legislation of the relevant country regarding prudential regulation and on-going supervision is “equivalent” to the provisions of the AIFM Directive. This procedure (the “equivalence procedure”) would become available three years after the deadline for implementation of the AIFM Directive.

The Commission Proposal’s equivalence procedure was criticized as protectionist and cumbersome, and neither the Council Version nor the ECON Version follows the Commission’s approach. Under the Council Version, non-EU AIFMs could continue to market AIF interests to the extent permitted under applicable Member State law without limitation in time, but only if an appropriate cooperation arrangement existed between the relevant authorities and subject to compliance with the AIFM Directive’s disclosure and reporting obligations.

Under the ECON Version, non-EU AIFMs could be authorized under the AIFM Directive if they agree to comply with the AIFM Directive, but subject to a number of conditions. If the conditions are satisfied, non-EU AIFMs and AIFs would benefit from the EU passport on a non-discriminatory basis. One of the conditions, however -- that the AIFM’s home state regulator agreed to enforce the AIFM Directive – is unworkable, since a non-EU regulator, such as the SEC, would be unlikely to agree to enforce EU law. Other approaches to this issue – such as a non-EU AIFM registering with an EU Member State authority and submitting to EU jurisdiction – would be required. Nonetheless, with the Council opposed to treating non-EU AIFMs on a non-discriminatory basis with EU AIFMs under any circumstances, the ECON Version approach seems to be the best hope to arrive at a regulatory framework that would create a level playing field for EU and non-EU AIFMs.

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