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NOTE

from:	Presidency
to:	Delegations
Subject:	Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/…/EC - Issues note by the Presidency

Delegations will find attached an issues note by the Presidency on the above mentioned subject.

AIFM DIRECTIVE - ISSUES NOTE FROM THE PRESIDENCY

INTRODUCTION

The Swedish Presidency has done a remarkable job conducting the debate on the proposed Directive to reach a compromise text. The last Presidency compromise proposal (hereafter, "the Council's text") was sent to COREPER on December 17 together with a progress report in which the incoming Presidency was invited to continue the work on the basis of that compromise proposal, at the same time, pursuing contacts with the European Parliament with a view to approve the text in the first reading.

The Spanish Presidency (hereafter, "the Presidency") believes that it could be useful at this moment in time to analyze the regulatory models embedded in both the Council's and the Parliament's drafts. The aim of this document is therefore to contribute to the debate by describing and comparing the options and solutions put forward by both institutions in order to find some common ground on the defining features of the regulatory model sought for AIFM. The topics listed below seem to have raised the most controversial viewpoints in relation to the basic structure of the Directive.

1. Scope.
2. Valuation.
3. Depositaries.
4. Remuneration policies.
5. Leverage.
6. Disclosure requirements for funds controlling listed and non listed companies.
7. Third country regime.

The Presidency would appreciate to know the delegations' positions in relation to the different options and solutions put forward by both texts.

1. SCOPE

On the one hand, the Council's text maintains the thresholds determining the managers that would be covered by the Directive and, on the other hand, imposes on Member State an obligation to register those managers falling below the thresholds and, therefore, outside the scope of the Directive. On the contrary, the European Parliament's *rapporteur* in his report (referred to hereafter as "the Gauzès report") removes such thresholds and advocates, instead, for applying the proportionality principle where necessary in order to adapt to small managers and the nature, scale and complexity of their business. This principle, however, is only explicitly used in article 16, where rules about valuation are not applied to private equity funds.

The Council's text seeks to adapt to different types of managers in a number of provisions, reflecting the fruitful debates held in the working group on the need to tailor rules to the different types of managers falling inside the scope of the directive. The text includes the following adjustments that recognize differences either in scale and complexity or nature/type, or both:

- Regarding initial capital and own funds, managers falling outside the scope of the directive and opting in may reduce their initial capital to EUR 50,000 , (instead of EUR 125,000 or EUR 300,000 as provided by the general framework) as long as (i) the manager is not leveraged at the level of the fund, (ii) the fund has no redemption rights exercisable during a period of 5 years following the date of investment in the fund, and (iii) investments and disinvestments are solely made on a non-frequent basis (article 6a).
- In respect of remuneration policies they have to be proportionate to the nature, scale and complexity of the manager's activities and to the AIF it manages (articles 9a).
- The risk management function and the portfolio management function have to be separated as far as it is appropriate and proportionate in view of the nature, scale, and complexity of the manager and the fund it manages (article 11).
- The provisions about liquidity management do not apply to those managers managing unleveraged close-ended funds (article 12).
- The functional independence between the valuation and the portfolio management functions is limited to those cases in which it is appropriate in view of the nature, scale and complexity of each AIF it manages. In addition, the evaluation shall be carried out, in case of open-ended funds, at a frequency that is appropriate given the specificities of the underlying assets and the issuance and redemption policies, without prejudice to the general rule establishing a periodicity of at least once a year (article 16).
- The depositary for AIF which have no assets which can be safe-kept may be an entity, subject to certain professional requirements, other than credit institutions, investment firms, or legal persons authorized to act as a depositary (article 17).

2. VALUATION

The Council's text currently allows for valuation being carried out by the manager and by an independent valuer, at the manager's choice. In the former case, the manager has to ensure independence between the valuation and the portfolio management functions as far as it is appropriate in view of the nature, scale and complexity of each AIF it manages. Moreover, the text allows (rather than imposes) competent authorities to require the verification of the procedures or the valuations themselves by an external valuer or an auditor. When an external valuer is used, the manager has to carry out a due diligence process when selecting the valuer. In both cases, the text allows (rather than imposes) home Member States to require that the valuation be subject to the oversight function of the depositary.

The Gauzès report also removes the notion of an "independent valuer" and envisages the valuation as an independent function within any party appointed to undertake valuation, which must be an authorised and supervised entity (amendments 61, 64, and 65). The notion of independence should however be embedded in the processes followed by these entities (amendment 64).The Gauzès report allows the delegation of this function to a third party, however such delegation does not affect the responsibility of neither the manager nor the depositary. Both entities are jointly responsible for the proper valuation of assets (amendment 62).

As regards frequency of valuation, the Council's text requires valuation at least once a year and for open-ended AIF the frequency should be appropriate given the specificities of the underlying assets held by the AIF and its issuance and redemption policy. Under the Gauzès report, the COM proposal is maintained (ie, valuation being carried out at least once a year and each time shares or units are issued or redeemed, if it is more frequent). However the rules on valuation do not apply to private equity funds. The text does not provide a definition of this type of funds, though.

3. DEPOSITARY

Country of establishment

As far as the scope of the provisions about the depositary is concerned, the Council's text limits these provisions to funds established in the European Union, explicitly leaving funds established outside the Community out of this regime. When applicable, the regime requires the depositary to be established in the Member State where the fund is also established.

The Gauzès report also distinguishes between funds established ("domiciled") inside and outside the European Union, but the general principle states that in both cases the depositary has to be established ("registered office") in the Union. When the fund is domiciled in the Union, the depositary, in addition, must have its registered office in the Member State where the fund is domiciled, as also stated in the Council's text. On the contrary, when the fund is not domiciled in the Union, the general principle can be exempted as far as certain conditions are satisfied, such as (i) the existence of cooperation agreements, (ii) equivalent regulation on depositary's issues, and the compliance with (iii) rules on prevention of money laundering and terrorist financing as well as (iv) the OECD Model Tax Convention (see amendment 75).

Eligible entities

In relation to eligible entities, the Council's text includes (i) credit institutions and (ii) investment firms having its registered office in the Union. Mirroring the UCITS directive, it also includes (iii) other legal persons authorised by the home competent authority of the manager that are subject to prudential regulation and ongoing supervision and that have sufficient financial and professional guarantees. Finally, the Council's text also allows, in case of funds having assets that cannot be safe kept, that the depositary's functions be undertaken by an entity which carries out these functions as part of its professional or business activities, which is subject to professional registration or to rules of professional conduct, and which has sufficient professional and financial guarantees. The Gauzès report, however, shows a more restrictive view on this respect and limits the possibility to undertake these functions to (i) credit institutions and to (ii) investment firms.

Liability

Regarding liability issues of depositary, the Council's text establishes that in case of loss of financial instruments that are held in custody by the depositary, there is an obligation to return assets of identical type without undue delay. This strict liability may however not apply in case of loss of financial instruments held by a sub-custodian, since the depositary may discharge itself from the liability, on a contractual basis, as far as (i) the depositary has fulfilled the requirements established for that delegation and (ii) there are objective reasons for such a discharge of liability. For the rest of the depositary's duties, liability arises whenever the depositary fails to perform its obligations. Finally, the Council's text explicitly includes a *force majeure* clause to discharge the depositary from any kind of liability.

The Presidency is inclined to read the Gauzès report as also distinguishing between the depositary's liability in case of loss of financial instruments and its liability in case of failure to perform the rest of its duties. In the first case, the general principle seems to be the restitution of the assets, although the text alludes to national law, which introduces some uncertainty. In any case, such liability may be shifted to an authorised third party entrusted with the custodial functions whenever the depositary is legally prevented from exercising its custodial functions in a third country. This shift has to be included in a contract between the manager, the depositary, the third party and the investor. This contract would not be necessary if the law of the country where the sub-custodian is established is equivalent to that of the European Union in the sense explained in amendment 75. For the rest of its duties, the depositary is liable for the unjustifiable failure to perform its duties or for the improper performance of them. The Presidency is uncertain of the actual consequence, if any, of adding "unjustifiable" as a specification of the failure to perform its duties and wonders whether it could have similar effects than the *force majeure* clause included in the Council's text.

Finally, the Gauzès report mentions the use of prime brokers. In these cases, the delay for restitution of any financial instruments that have been lost shall reflect the terms of the contract passed between the depositary and the prime broker.

4. REMUNERATION

The Council's text introduces the obligation for managers to put in place sound remuneration policies and practices. These have to be proportionate to the nature, scale and complexity of the manager's activities and to the funds it manages. CESR should adopt guidelines which have to comply with the principles set out in the annex. In addition, the Council's text also establishes some transparency requirements such as the obligation to include in the annual report of the fund the total amount of remuneration of the financial year (article 19).

The Gauzès report also introduces, although with a different wording, the obligation to have remuneration policies in place which are compatible with the rules applicable to credit institutions and investment firms. When adopting implementing measures on conflict of interest provisions the Commission would have to ensure that they are in line with rules on remuneration. It also introduces some disclosure requirements in the annual report (amendment 89) and information obligations toward their competent authorities (amendment 51). Competent authorities would have the right to take appropriate corrective measures to offset risks that might result.

5. LEVERAGE

The Council's text regulates leverage through certain disclosure requirements imposed on those managers employing leverage on a systematic basis. Managers should disclose to investors the total amount of leverage employed and the maximum level of leverage that the manager may employ (article 20); and should make available to their home Member State competent authority information about the overall level of leverage and major counterparties. Regarding the possibility of establishing limits to leverage, competent authorities are the ones entitled to impose limits, under certain circumstances, on the level of leverage incurred by managers. They have to inform the competent authority of the fund, CESR and the ESRB. There are also level 2 measures envisaged to further harmonise the circumstances under which leverage limits can be set by Member States.

The Gauzès report endorses the reporting requirements established by the Commission (hereafter, "the COM") to both investors and competent authorities and introduces a relevant role for the new European Securities and Markets Authority (ESMA). It also drafts a regime in which managers must set leverage limits in respect of each AIF they manage, and in which the COM would be entitled, in the event that ESMA has determined that the leverage employed by an AIFM poses a substantial risk to the stability and integrity of the financial system and taking account of the advice of the ESRB, in exceptional circumstances to impose temporary limits on the level of leverage that AIFM could use.

6. OBLIGATION FOR MANAGERS ACQUIRING CONTROL OF NON LISTED COMPANIES

In the Council's text most of the regime applicable to those managers reaching control of a company that is not a small or medium sized enterprise is addressed to non-listed ones, although some of the rules would also apply to listed companies. Managers have, in the first place, to communicate to the company and its shareholders the fact that it has reached control. Then they need to inform them and the employees of the company of the policy for preventing and managing conflicts of interest. In addition, the manager has to provide competent authorities of its home Member State, as well as the investors of the fund, with information about debt supported directly or indirectly by the company before and after control has been reached by the manager. This requirement also applies in case of the acquisition of control in listed companies. Finally, managers have to include certain information in the annual report of the fund about the non-listed companies that they control, i.e. the operational and financial developments, capital structure, companies' operation and activities, the number of employees or significant disinvestments of assets.

The Gauzès report does not introduce any major change in this regard compared to the COM proposal but for the change of the "controlling influence" concept since the reference to the 30% or more of the voting rights is removed. Some reporting requirements, especially for non-listed companies, have been deleted. Implementing measures of the Commission are removed. Notwithstanding this alignment, the Gauzès report shows its concerns on whether, and to what extent, these rules may create a competitive disadvantage to AIFM *vis-à-vis* other investors, and it therefore requests the Commission to conduct a review of the relevant legislation on company law to ensure a level playing field on this topic (amendment 15).

7. THIRD COUNTRY REGIME

The notion of marketing is a key element of the directive's structure and, particularly, of the third country regime. Both the Council's text and the Gauzès report define marketing more narrowly than it is defined in the COM proposal so as to exclude the so-called passive marketing. The Presidency believes that in order to clarify the different views on the third country regime, the following scenarios must be carefully analysed:

AIFM established in the Union

The Council's text provides the following:

a) If the AIF is established in the Union, the directive applies in full.

b) If the AIF is established outside the Union but marketed in a Member State, the only rules that do not apply (compared to the case of EU domiciled AIF) are those on depositaries. It should however, be noted that in this specific case, additional provisions (article 34a) are imposed on the EU AIFM. They govern the conditions which have to be fulfilled by the third country AIF and its domicile that would allow an EU domiciled AIFM to manage the AIF in question. One should also underline that it is a Member State decision, pursuant to Article 31 (4)a, to allow the marketing of these funds on their territory or not.

c) If the AIF is neither established nor marketed in the Union, the directive applies with the exception of the rules on (i) depositaries, (ii) the obligation to make available an annual report to respect of those AIF, and (iii) the rules to manage and market AIF in the Union. It follows that also article 34a applies, which implies that the AIFM has to fulfil certain additional requirements, that is, (i) the AIF has to comply with international standards in its country of establishment and (ii) there has to be a cooperation agreement in place between competent authorities of the home Member State of the AIFM and competent authorities of the third country where the AIF is established.

The Gauzès report also establishes that the directive only applies to AIFM established in the Union, but it qualifies this rule by stating that this application is irrespective of whether the AIF is established ("domiciled") inside or outside the Union. Therefore, the domicile of the AIF does not determine the provisions applicable to the AIFM. This being said, the Gauzès report provides for some specificities in certain provisions whenever the AIF is established ("domiciled") in a third country.

a) As it has been explained in paragraph 3, there are some particularities on the depositaries' regime.
b) These AIF do not benefit from the passport to market their unit or shares within the Union, which implies that their marketing is subject to Member States' national regimes for their particular territory.

The Gauzès report also establishes some limits to the marketing of funds of funds investing more than 30% in third country AIF to retail investors (amendment 119).

AIFM established outside the Union

The Council's text takes the view that the directive does not apply to these cases, which implies that current status prevails and national regimes apply no matter whether the AIF is marketed actively or passively.

The Gauzès report establishes some conditions to allow Member States to have third countries' AIF managed by third countries' AIFM and marketed inside the Union. In such case, the Gauzès report requires a cooperation agreement and efficient exchange of information between (i) the Member State where the AIF is intended to be marketed and the third country where the AIF is established, (ii) the AIFM and its supervisor and (iii) the AIFM's supervisor and ESMA. Similarly, the Gauzès report limits the possibility for professional investors to invest in AIF established outside the Union to AIF established ("registered office") in third countries which have signed information-sharing cooperation agreements in line with relevant international standards (amendment 126). This is the only instance in the Directive where obligations would be imposed on investors rather than on the AIFM.