COUNCIL OF
THE EUROPEAN UNION

Brussels, 2 September 2009

12864/09

Interinstitutional File:
2009/0064 (COD)

EF 112
ECOFIN 545
CODEC 1056

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 with regard to the above-mentioned Commission proposal.

AIFM – ISSUES NOTE FROM THE PRESIDENCY

I. Introduction

During the first meetings of the Working Party and as a result of written comments received from Member States, the Presidency has identified a number of key issues in the AIFM proposal that need to be addressed. These issues have been grouped below, together with some suggestions for possible ways forward.

The directive covers managers of a very heterogeneous group of funds with different business models, risks, redemption policies etc. Many delegations have therefore called for a refinement in the differentiation of the requirements as they pertain to different funds. There are indeed provisions in the proposal which from a technical point of view do not seem relevant for all funds, especially those without redemption rights. Here changes can be made within the specific articles by further specifying their scope of application. But since these changes have been deemed to be of a mostly technical nature, they will not be treated in this paper.

Other issues, e.g. the authorisation and passport procedures, have also been deemed to concern mainly technical drafting and possible alignment with other directives and are therefore not dealt with here.

II. Scope (Articles 2, 3 and 4)

Issues/questions raised by delegations concerning the scope have been divided into three categories below. These include 1) inclusion in the scope based on the definition of an AIF in Article 3, 2) exemptions from the scope in Article 2 (including thresholds) and 3) questions concerning the possible requirement of “double authorisation” for entities whose business includes but is not limited to managing AIF, as well as for entities which provide services to AIFM but are not themselves AIFM (Article 4).

1. The definition of AIF

According to the proposed definition in Article 3, *'Alternative investment fund' or AIF means any collective investment undertaking, including investment compartments thereof whose object is the collective investment in assets and which does not require authorisation pursuant to Article 5 of Directive 2009/…/EC [the UCITS Directive]* (Article 3 (a)).

The scope of the AIFM Directive is specified in more detail in Recital 5. There it is stated that the Directive '*should be confined to the management of collective investment undertakings which raise capital from a number of investors with a view to investing it in accordance with a defined investment policy on the principle of risk-spreading for the benefit of those investors*'.

There general view of delegations seems to be that the current wording does not make it sufficiently clear what entities will be under the scope. Moreover, there is a also risk that entities which should clearly not be the target of the Directive might be inadvertently caught. In addition, some AIF may take very concentrated positions (i.e. do not operate on the principle of risk spreading), which would imply that the managers of such funds would fall out of the scope of this directive.

The Presidency believes that the definition of AIF should be the starting point for questions related to the scope. In this context, focus should be on *the notion of a collective investment undertaking*, i.e. the kind of entity that should be caught under the scope in accordance with the objectives of the proposed Directive.

The way forward as concerns the definition of collective investment undertaking could therefore be to

a) clarify the definition of AIF by including what is now specified in Recital 5, i.e. that AIF means collective investment undertakings which raise capital from a number of investors with a view to investing it in accordance with a defined investment policy on the principle of risk-spreading for the benefit of those investors (however, some delegations have suggested that '*on the principle of risk spreading*' should be deleted, as some AIF as a business model take very concentrated positions); and

b) combine this "chapeau" with a list of more detailed criteria (such criteria need not be cumulative);

c) confer powers to the Commission to adopt implementing measures to further specify the content of the criteria included in the definition;

d) introduce further clarification in Recital 5.

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2 a) Exemptions in general

A number of clarifications in this aspect have been sought. In particular, delegations have questions concerning

- whether or not self managed collective investment undertakings are included (compare with the UCITS Directive and the provisions regarding investment companies and the specific provisions for self managed investment companies);

- the consequences if the directive would cover common private or public limited companies or holding companies;

- the risk that funds of the closed-ended type which are subject to the provisions of Directive 2003/71/EC ("the Prospectus Directive") and listed funds of the closed-ended type which are subject to the provisions of Directive 2004/109/EC ("the Transparency Directive") would be subject to a "double layer" of regulation;

- whether or not securitization vehicles, managed accounts and investment in the form of securities such as managed futures should be exempted;

- the treatment of credit institutions, pension funds and insurance undertakings which manage AIF;

- if state controlled pension funds within a compulsory or voluntary national pension system and employee pension funds under national law and central banks should be exempted;

- the possibility to introduce an exemption of the same type as in Article 3 (b) of the UCITS IV Directive, i.e. that ”collective investment undertakings which raise capital without promoting the sale of their units to the public within the Community or any part of it” should be exempted;

- whether or not there should be an explicit exemption for investment made only within the same group of companies.

The way forward as regards exemptions in general could be to

a) clarify whether certain types of managed accounts and/or managed futures funds should be exempted or not;

b) clarify whether self managed funds in general should be exempted or not;

c) clarify that the Directive shall not include state controlled national pension or social security systems;

d) consider to exclude from the scope of the Directive funds of the closed-ended type in general; or

e) make the same exemption as in d), but limit it to self managed funds (to ensure that the Directive will not include undertakings that are common private or public limited companies or holding companies); or

f) make the same exemption as in d), but limit to self managed funds which have no leverage;

g) exclude funds of the closed-ended type from the provisions on marketing and disclosure in order to avoid rule conflicts with the Prospectus Directive;

h) consider to exclude from the scope of the AIFM Directive funds the shares or units of which are admitted to trading on a regulated market when it comes to the transparency requirements in the Directive, in order to avoid rule conflicts with the Transparency Directive;

i) exclude securitization vehicles;

j) exclude collective investment undertakings which raise capital without promoting the sale of their units to the public within the Community or any part of it;

k) exclude investment which is made only within the same group of companies.

2 b) The *de minimis* thresholds

Member States have expressed concerns about;

- how the *de minimis* thresholds should be applied, especially concerning the calculation of the portfolio values and the treatment of AIFM which manage portfolios where the value fluctuates and is sometimes above and sometimes below the thresholds;

- the need to remove these thresholds.

The way forward could be either to

a) clarify this exemption, e.g. the calculation of portfolio values and the treatment of AIMF with fluctuating portfolio values (Article 2(2)(a) and maybe also Level 2); or

b) delete the thresholds.

The first alternative implies only a technical solution. The second alternative implies a principled solution which would require further consideration on how the provisions of the AIFM Directive could be tailored to be proportionate and not unduly burdensome for AIFM managing certain types of funds (e.g. managers of venture capital funds).

<u>2 c) Credit institutions, investment firms and other institutions managing AIF</u>

Delegations have called for clarification of the treatment of credit institutions and other institutions managing AIF. The issue of what services investment firms can provide to AIF has also been raised.

The proposal explicitly states that an AIFM may hold an authorisation pursuant to the AIFM Directive and be authorised as a management or an investment company pursuant to the UCITS Directive (Article 4(2), second subparagraph).The proposal exempts credit institutions (Article 2(2)(d)). Pension funds and insurance undertakings are also exempted (Article 2(2)(e) and (f)).

The proposal does not mention investment firms in the articles. However, according to the recitals investment firms authorised under Directive 2004/39/EC ("MiFID") should not be required to obtain an authorisation under this Directive in order to provide investment services in respect of AIF (see Recital 5, investment firms are also mentioned in Recitals 9 and 10).

For level-playing field reasons it seems appropriate that a credit institution, a pension fund or an insurance undertaking managing one ore more AIF should be considered to be an AIFM and thus subject to the AIFM Directive when they manage AIF for third parties. Other activities performed by such institutions apart from managing AIF for third parties should be subject solely to the relevant regulation of the concerned activities.

The way forward could therefore be to clarify that the exemption for credit institutions, pension funds and insurance undertakings should be limited to cases where such institutions only manage AIF on their own account.

For investment firms and credit institutions, it could be clarified in an article that such firms should not be required to obtain an authorisation under the AIFM Directive in order to provide investment services in respect of AIF.

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3. Double authorisation?

Concerns in this area include the following:

– whether or not there is a need for ”double authorisation” for entities other than AIFM managing AIF and what other authorisation/s an AIFM may hold (Article 4(2);

– if companies authorised under MiFID may need another authorisation under the AIFM Directive, even if they only *market* AIF and do not manage them (Article 4(1)).

The proposal is clear about the requirement for double authorisation for UCITS management companies when they also *manage* AIF (authorisations pursuant to the UCITS Directive and the AIFM Directive). However, there are alternatives to double authorisation both for UCITS management companies and other institutions managing AIF.

The way forward could be to

a) require double authorisation for UCITS management companies and other institutions such as credit institutions, investment firms, pension funds and insurance undertakings that manage AIF; or

b) introduce the same model in the AIFM Directive as in the MiFID, where it is stated which provisions of that directive that shall apply to credit institutions when providing one or more investment services and/or performing investment activities (Article 1(2)); or

c) include in the AIFM Directive a provision that states that at least UCITS management companies do not need authorisation pursuant to that Directive to manage AIF.

In addition, if double authorisation were to be required for all affected types of institutions, it seems that credit institutions, investment firms, pension funds and insurance undertakings should be included in Article 4(2), second subparagraph.

It would in that case also have to be clarified in Article 4(1), both subparagraphs, that those provisions only affect the provision of management services, and not marketing.

III. Definitions (Article 3)

Several delegations have expressed concerns about some of the definitions, and have asked for clarification and amendments especially regarding the definitions of AIF, management services, marketing and leverage (Article 3 (a), (d), (e) and (l)).

The definition of *AIF* in Article 3 (a) has been commented on in section II above.

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1) Management services

Some delegations have suggested that the definition should refer to Annex II of the UCITS Directive while other delegations have only asked for clarification.

The way forward could be to

a) define management services as any function referred to in Annex II of the UCITS Directive; or

b) clarify the definition in an annex to the AIFM Directive, where the management services functions that are relevant for AIFM are specified.

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2) Marketing

A number of delegations have commented on this definition and there seems to be an overwhelming majority of Member States which are against introducing a definition which would include cases where shares or units of an AIF are purchased at the investor's own initiative. This issue is highly related to the possibility for EU investors to purchase shares and units of third country AIF, see the options in section X below.

The way forward could be to align the definition of marketing in the AIFM directive with the definition of marketing in other sector directives.

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3) Leverage

Several delegations have expressed concerns about the definition of leverage, which they believe is ambiguous. See also section VIII below regarding the proposed special provisions on leverage (Articles 22 to 25).

The way forward could be to clarify the definition, i.a. that it is the AIF's exposure itself which is increased through this leverage and not the AIFM's or one of the AIF's portfolio companies, i.e. the relevant measure should be the leverage at the level of the AIF. The definition could also make clear that leverage should be considered on a netted and risk-weighted basis, in order for different underlying assets and netting methods of the specific AIF to be taken into account.

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Some delegations have suggested minor re-drafting of a few other definitions and that additional definitions should be included. In general, these suggestions concern standard definitions in other directives. However, we will return to them at a later stage in connection with the drafting of a compromise proposal.

IV. Capital (Article 14)

Several delegations have pointed out the differences in relation to the corresponding provisions in the UCITS IV Directive (Article 7(1)(a)), and have asked for alignment with that Directive.

The way forward could be to

a) align the proposed provisions on capital requirements with the corresponding provisions in the UCITS IV Directive;

b) clarify if a UCITS management company that manages one or more AIF should be required to hold an initial capital of two times EUR 125 000, i.e. to hold an initial capital according to both the UCITS IV Directive and the AIFM Directive;

c) consider the need for amending the capital requirements in the UCITS Directive (Article 7(1)(a)(ii) third indent) for non-UCITS to avoid double counting for UCITS management companies that manage one or more AIF and therefore have to fulfil the capital requirements in the AIFM Directive for that or those AIF;

d) consider to exempt from the capital requirements AIFM managing only AIF without redemption or repurchase rights/of the closed-ended type, or at least from the requirements that refer to the value of the portfolios of AIF managed by the AIFM or one quarter of the AIMF's preceding year's fixed overheads (Article 14, second and third subparagraphs).

V. Valuation (Articles 16 and 37)

A number of delegations are not satisfied with the proposal that the valuator must be independent of the AIFM. Arguments against this model are i.a. that it creates ambiguity as to who will be responsible for the valuation and that it does not make sure that the valuator is licensed and supervised. It may not lead to any benefits for certain business models, but instead impose unjustified costs and create problems where there may be a lack of independent valuators. It could also result in inferior valuation for business models where the AIFM itself would have the best information (e.g. regarding the value of portfolio companies). To require an independent valuator also seems too strict in relation to open-ended funds which invest mainly in liquid assets, where the market value can be easily determined. This is particularly the case for funds with daily redemption rights.

At the same time, it should be possible to require an independent valuator, where appropriate. It could be appropriate e.g. when an AIFM manages hard to value and illiquid assets, where an external check could be justified. However, the periodicity of the independent valuation should take into account the costs and benefits of independent valuation at different intervals (one example is real estate funds, where the periodicity may have to be adjusted).

The way forward could be to use the UCITS model, deleting the absolute requirement for an independent valuator but making it explicit in the text that the AIFM should be responsible for the valuation, regardless of whether an independent valuator is appointed or not. This would also solve the problem with e.g. private equity funds, where no redemption rights or performance fees linked to the NAV exist.

AIFM should also, where appropriate, ensure that the valuation function is independent of the management functions, in case valuation is conducted by the AIFM itself.

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As regards valuators established in third countries (Article 37), the proposed solution would make it more logical to treat the appointment of an independent valuator as delegation.

The way forward regarding Article 37 could therefore be to delete that Article and instead treat the matter under Article 16.

VI. Depositary (Articles 17 and 38)

Although delegations welcome a strengthening of investor protection in this area, many have expressed serious doubts about especially limiting eligible depositaries to EU credit institutions and also about the proposed rules on liability. A number of different arguments against the proposal have been raised, some of which are described below.

The first requirement could result in a substantial risk concentration in EU credit institutions. Since there would be a requirement to separate the assets concerned from other assets in the credit institution, the capital held by the credit institution would in itself not constitute a safeguard. The proposal also does not take into account the important role of prime brokers.

The provisions on liability could lead to difficulties in finding depositaries willing to take on such risks. At the same time, experience shows that there is a need to clarify the liability issue, including the burden of proof.

Given the global character of the activities of many market players, the current draft does not seem workable, as it in many cases will not be possible to hold the assets in the EU without incurring considerable costs for investors. It is the current practice to hold securities in the markets where they are traded. For investment in emerging markets, the additional costs of using an EU depositary could make investment in such markets impossible. Some third country jurisdictions also require the use of local custodians.

Moreover, for some funds, e.g. private equity funds, it does not make sense to impose these requirements, especially since such funds do not have redemption rights. Another specific issue that has been raised is what happens if a credit institution is itself an AIFM – will this disqualify it as a depositary?

All these issues need to be addressed. There are several different paths to consider, one being at least partial alignment with the current UCITS model. Another option could be to explore the relevant provisions in the MiFID implementing Directive.

A number of options are available, and some delegations have sent detailed suggestions on how the matter could be dealt with. However, it is the opinion of the Presidency that the matter should be put on hold for the moment and be revisited once the on-going consultation on UCITS depositaries has been finished.

Do delegations agree to this plan of action?

VII. Delegation (Article 18)

A number of delegations have expressed concerns about the proposed articles on delegation, and have asked for alignment with other directives, such as the UCITS Directive and MiFID, including with regard to third country issues. This relates especially to, i.a., the need for prior authorisation, what functions can be delegated and to whom. A possible division of core and non-core functions has also been suggested. A particular issue that has also been raised is that the proposal restricts delegation of portfolio management to other authorised AIFMs. This could seriously affect global players, where portfolio management is today carried out by delegation to managers close to the local markets in third countries.

The way forward could be to

a) align Article 18 on delegation with the provisions in the UCITS IV Directive, Article 13.1 (c), MiFID, Article 13(5), and the MiFID implementing Directive, Article 15, with necessary adjustments given that the AIFM proposal does not regulate the funds themselves; and (possibly)

b) divide the functions into core and non-core functions for the purpose of determining the need for authorisation or notification of delegation;

c) if the latter division would lead to a more restrictive approach than that of the UCITS IV Directive, consider amending the UCITS Directive to secure alignment between the directives; and

d) delete Article 36 and 37 and handle all, including third country, delegation issues within Article 18. Compare section V.

The suggestions above imply that delegation of investment management functions could be given to non-AIFM firms in the EU and in third countries and that administrative functions delegated to a third country need not be to an institution under supervision.

VIII. Leverage (Articles 3, 22–25)

A number of delegations have expressed concerns about the proposed articles concerning leverage. The concerns relate especially to the definition and calculation of leverage, the reporting to the competent authorities, the limits to be set by the Commission and the limits to be set in exceptional circumstances by the competent authorities.

For the definition, see section III above.

The threshold for when an AIF should be considered to be highly leveraged is difficult to set, not least due to the different types of AIF (with different strategies, leverage sources etc.) under consideration. It is however also necessary to achieve a robust definition of high leverage and at what points in time it needs to be calculated for classification purposes. If not it would be open for circumvention. It could possibly be connected with the levels of leverage allowed for in the AIF's prospectus/fund rules. This would also help take into account the specific strategy of the AIF (underlying assets, netting methods etc.). On the whole, the definition in Article 22, third subparagraph, of when an AIF should be considered to be highly leveraged appears a bit blunt.

The potential systemic risk from leverage and concentration of leverage needs to be addressed. Ex ante leverage caps, however, can give rise to procyclical effects which could exacerbate any instability on the markets. This is due to the fact that in a market downturn, a number of AIF might simultaneously breach their caps (the leverage ratio would automatically go up) which could trigger a mass de-leveraging, potentially deepening the downturn and affecting market stability.

Against this background, a *possible way forward could be to*

a) delete Article 22; or

b) delete the third subparagraph of Article 22 and replace this definition with implementing powers for the Commission in this regard; or

c) replace "equity capital" in that subparagraph with "net assets"; and

d) delete Article 25(3); and

e) redraft 25(4) to provide for the competent authorities to limit leverage when deemed necessary.

This last option would provide better possibilities for the competent authorities to take into account the risk profile of the individual AIF. It would also remove any pre-setting of the leverage level, while providing the competent authorities with the means to limit leverage should there be a possible threat to financial stability. At the same time, possible procyclical effects as described above could be avoided.

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It would of course be necessary to provide for increased information sharing between competent authorities in order for them to be able to analyse the risks of the effects of high leverage on the financial system as a whole. Some delegations have asked for a role for the coming ESRB and ESMA to be included. However, it seems premature at this stage to include amendments to reflect the coming new supervisory framework (compare section XI). But the Presidency would here like to point to the proposed provisions in Article 25, paragraphs 1 and 2. It could also be envisaged in a recital that the ESRB and the ESMA should have a role in this regard. The Presidency would also like to underline the commitment already made by Member States to include in the mandates of the national competent authorities that their decisions should take into account the financial situation of the EU as a whole.

IX. Obligations for AIFM managing AIF which acquire controlling influence in companies (Articles 26–30)

Delegations have voiced a number of concerns regarding Articles 26 – 30. The main issues relate to the possible overlap with other legal acts (i.a. concerning the definition of controlling influence, where the proposed threshold may not always allow for AIFM to fulfil their obligations) and the potential risk of creating an un-level playing field between especially private equity funds on the one hand and investors not covered by the AIFM Directive on the other. This latter problem seems particularly potent as regards Article 30. It has also been pointed out that due consideration must be taken to non-AIFM minority stake-holders in the affected companies. Overall, there is also a risk that the responsibilities of the AIFM on the one hand and the portfolio companies on the other could be blurred.

Against this background, *several options could be considered*.

Option 1: Limit the scope of application by raising the threshold in Article 26(2) (possibly in combination with option 3).

Option 2: Delete Articles 26 – 30, on the grounds outlined above.

Option 3: Retain Articles 26 – 29 (and possibly Article 30), but

a) align the concept of “controlling influence” with the Directive on takeover bids or, at least, raise the percentage to “levels over” 50 percent;

b) exclude listed issuers from the scope; and

c) delete obligations which fall under the responsibility of the portfolio companies themselves under existing rules (to be identified).

X. Third country issues (Articles 35–39)

A number of issues have been raised by delegations as concerns AIF and AIFM domiciled in third countries. Although proposals on how to solve these issues vary, there seems to be an overwhelming majority of Member States which are against imposing undue restrictions on investment opportunities for especially institutional investors, as well as creating other barriers to global capital flows. Delegations have also pointed to that the AIFM Directive should, as far as possible, be consistent with global standards. At the same time, delegations have recognized the need for sufficient safeguards, in order for the objectives of the AIFM proposal to be achieved, in this case mainly the interest of investor protection.

Several different options could be considered as regards Articles 35 and 39:

Option 1: Retain both articles, but make it explicit in Article 35 that *investment* in a third country AIF should only be allowed where the AIFM managing the AIF is domiciled in a Member State or where there is a cooperation agreement on information-sharing between the third country where the AIFM is domiciled and the Member State/s where the AIF is marketed.

Option 2: Retain both articles, but make it explicit in Article 35 that *marketing* of a third country AIF should only be allowed where the AIFM managing the AIF is domiciled in a Member State or where there is a cooperation agreement on information-sharing between the third country where the AIFM is domiciled and the Member State/s where the AIF is marketed.

Option 3: Delete Article 39, but retain Article 35.

Option 4: Delete Article 39, retain Article 35, but make it explicit in the latter article that investments in a third country AIF should only be allowed where the AIFM managing the AIF is domiciled in a Member State or where there is a cooperation agreement on information-sharing between the third country where the AIF is domiciled and the Member State/s where the AIF is marketed.

Option 5: Keep status quo by deleting both articles, but change the definition of "marketing" in Article 3 to allow for investors to purchase units of third country AIF at their own initiative (possibly subject to the national law of the Member State where the investor is domiciled).

If Article 35 is to be retained, it could also be considered to delete the last two subparagraphs of that article, as these imply that the funds themselves require authorisation.

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Chapter VII also contains three articles on delegation of administrative tasks (Article 36), valuators in third countries (Article 37) and delegation of depository tasks (Article 38). These issues are dealt with in relation to Articles 16 – 18 above.

XI. Supervision (Article 32, Chapter VIII)

A number of delegations have expressed concerns about the proposed articles on supervision, and have asked for alignment with other directives. This relates i.a. to the absence of powers for the host authority in the proposal. It also concerns the issue of which authority should be responsible for the supervision of the AIF and what rules should apply in this situation (including marketing to retail investors).

The way forward could be to

a) align the articles on supervision with the relevant articles in the UCITS IV Directive, with necessary adjustments given that the AIFM proposal does not regulate the funds themselves;

b) clarify that the authority in the Member State where the AIF is located should be responsible for the supervision of the AIF (where relevant) and that the authority of the Member State where the AIF is marketed should be responsible for the supervision of any marketing to retail investors (where relevant). Needless to say, the rules of that Member State should be applicable as regards the rights of an AIFM to market to such investors.

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Some delegations have also asked for changes to be introduced in order to take into account the coming new supervisory framework. However, although the AIFM Directive will most probably have to be amended at some stage to reflect the new framework, it seems premature to make those changes now.

The way forward could be to introduce a new recital pointing to the future amendments that will have to be made as a consequence of the new supervisory framework (compare section VIII).