

Asset Management

AIFMD News

Drawing the battle lines

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Introduction

The purpose of this note is to provide an update on recent events around the AIFMD and to outline our views on what is most likely to happen over the next few months.

European Parliament and Council votes

May was a tumultuous time for the AIFMD. Early stories surfacing in the UK press just after the UK General Election spoke of George Osborne (UK Chancellor of the Exchequer) preparing to go to Brussels to fight the “Hedge Fund Directive” but facing an immediate and hostile barrage from France’s President Sarkozy and Germany’s Chancellor Merkel. At the same time, a European Parliament draft Directive was circulating with some proposals for text, derived from European socialist MEPs, which would have been game changing for the Private Equity industry. Then in the middle of the month came the votes of the European Parliament’s ECON Committee and the Council’s ECOFIN Committee, adopting their respective positions for the upcoming trilateral negotiations.

In the event, the meetings of ECON and ECOFIN passed off relatively uneventfully. On Monday 17 May, Sharon Bowles, the liberal UK MEP chairing the ECON Committee, assisted by J P Gauzès, the Rapporteur, shepherded a draft directive through the Committee which was less hostile to industry than had been feared, but which still contains provisions which are extremely onerous, including third-country provisions which may prove unworkable.

On Tuesday 18 May, the ECOFIN Committee, under the Spanish Presidency, adopted its negotiating draft, reverting to a draft of the Directive circulated at the beginning of March, reflecting the fact that there has been little overt Council activity

on the Directive since then, pending the outcome of the UK Election. The Council noted the reservations expressed by the UK and Czech governments, who have drawn their lines in the sand for upcoming negotiations but who did not try to derail the vote, the outcome of which has been, since March, a relatively foregone conclusion.

The Council and the European Parliamentary drafts have evolved considerably from the original European Commission draft of May 2009 and diverge significantly in a number of key areas, while reflecting common positions in a number of areas not necessarily helpful to the industry. The main points to note on the key issues in the Directive are as follows:

- **Scope:** The AIFMD remains massively broad in scope, catching the managers of virtually all collective investment vehicles which are not UCITS and which are not industrial holding companies or otherwise within a limited set of categories of exemptions. Certain industry sectors - Private Equity, Real Estate and self-managed listed enterprises, may be, based on current drafts, carved out of certain but not all operative provisions. Overall, many more entities will be subject to regulation than before and there is not yet clarity on whether there will be effective de minimis provisions. Little or nothing has been said or written regarding grandfathering provisions.

- **Regulatory requirements:** Managers and self-managed funds will be subject to a raft of new or more stringent requirements including: (i) an independent valuation function which has to value assets on a periodic basis, (ii) preparation of detailed accounts for themselves and each fund they manage with extensive transparency requirements, (iii) regulatory capital requirements which increase depending on the size of funds under management. They will need to have internal policies, procedures and controls to deal with proper governance, management of conflicts, control of liquidity and other internal functions. They will need to monitor short selling and leverage and deliver regular reports to regulators.
- **Depositaries:** With limited exemptions for certain funds, introduced in later drafts (notably the European Parliament exemption from the depositary requirements for private equity and real estate funds), all funds must have depositaries who will have responsibility and direct liability to investors, and whose functions will be expanded to include not only safe custody but also various monitoring and supervision responsibilities as regards manager activity. The general message is the same across both drafts but there are differences in the detail to be negotiated in particular around levels of liability and location of depositary.

- **Delegation:** The ability of managers to delegate various functions to third parties will be subject to significant constraints, including, in the European Parliamentary draft, a complete ban against delegating asset, risk and liquidity management responsibilities other than to an AIFMD authorised firm. The pre-approval required for delegation of any manager function is in both drafts and introduces a significant additional level of regulatory intervention.
- **Third countries:** There remains a great deal of talking to be done to achieve agreement on these provisions which deal with the rights of EU and non-EU managers to market funds established outside the EU to EU investors. The European Parliament draft introduces stringent and detailed compliance and co-operation requirements for EU managers to market non-EU funds in the EU; for non-EU managers the same rules apply plus additional onerous requirements including, for example, the supervision by the third-country regulator of the manager's compliance with the Directive. The Council requirements which would permit marketing in Member States subject to compliance with some provisions of the Directive and co-operation arrangements with the third-country seem mild in comparison. Both versions, however, require regulatory preconditions to be met in order to permit the ability to market non-EU funds in the EU and limit investor choice. The European Parliament also seeks to introduce an extremely harsh and damaging prohibition on EU investors making individual investment in third-country funds where the stringent conditions of the Directive are not met by that third country.
- **Leverage:** The main provisions require managers to provide information on leverage to regulators and to assess the level of risk regularly. The European Parliament draft includes provisions requiring disclosure to investors of the leverage limits of funds and regular updates on the leverage position. It also contains a raft of considerations which must be taken into account by a manager in respect of each fund it manages, which again seem inappropriately to require managers to substitute the Directive's requirements for their own judgement as to what might be appropriate in particular circumstances.
- **Remuneration:** Both drafts contain disclosure requirements and rules on the formulation of remuneration policies to limit "excessive risk taking", with the European Parliament also requiring similar rules as those applying to investment firms. The detail is subject to negotiation but it is clear that fund managers will be subject to a level of transparency on terms of remuneration and deferral of payment the like of which they have not seen before.
- **Reporting controlling positions:** The Council draft has a requirement on managers to report holdings in unlisted vehicles where the interest is at or exceeds 50%. However, the European Parliament's text requires notification at the points where holdings reach 10%, 20%, 30% or 50% of voting rights. The text on which the European Parliament voted removed some of the provisions which were particularly burdensome and concerning, for example, the requirement to notify future intentions to acquire further holdings and the most stringent anti-asset stripping provisions.

What happens next?

The next big question is “what happens now?”. In short, negotiations between the European Parliament, the Council and the European Commission.

These commenced on 31 May 2010 and are continuing, with some 5 meetings having been scheduled by the Spanish Presidency over a short timeline. We do not yet know the make up of the Council negotiating team, although we do know that they will be taking some industry concerns into the meetings with them. The European Parliament has pinned its colours to a draft which reflects the views of a wide spectrum of European political groups, with particularly high levels of contribution from the

European Socialists, but with relatively little input from European liberals, who abstained at the actual vote. We know the Commission, whose role in the negotiations is to try to help the Council and European Parliament find a middle ground, have recognised that their original draft Directive was deeply flawed but still remains committed to a “strong directive”.

Early intelligence indicates an alignment between Parliament and the Commission in support of quite stringent 3rd country provisions, but supportive of a Passport but there is a lot to play for and the dialogues will be interesting.

When will we have clarity?

In answer to the larger timing question and to the question “when will we have clarity”, this unfortunately remains unclear. The three sides have got a lot of ground to cover and some political positions are deeply entrenched. It was originally proposed that the European Parliament should vote on a final text in July. Although this is still the aim and the ambitious meeting schedule proposed by the Spanish Presidency supports this goal, there can be no certainty this timetable can be met, given the issues remaining for negotiation and the distance between the European Parliamentary, Commission and Council positions. As an administrative matter it is thought agreement would need to be reached by the middle of June to enable the vote in the first week of July. If that is not achieved then the vote is likely to take place in September if an agreed draft is available.

Synthesizing the European Parliamentary and Council drafts will not be an easy task – in some key areas there is no obvious compromise position between the polar political differences in the texts. What is clear though, is that unless a very unexpected debacle occurs, there will be a Directive this year and that many currently unregulated firms will be swept into the new regime, custodians and depositories will have their duties and responsibilities widened and deepened (with knock on consequences on costs to be borne by investors and savers), European SMEs will find their cost of capital raised as private equity houses accommodate and possibly retreat from investing in European enterprises to avoid onerous disclosure provisions, and the ability of non-EU domiciled funds and managers to access European investors will be constrained, although exactly how remains to be seen.

What should you be doing?

As we have indicated in previous AIFMD Newsletters, although the windows for lobbying are closing, it is still worth while continuing to seek out MEPs and to encourage them to reflect on the potential risks of the Directive to the real economy and the long term prospects for savers and pensioners.

From a business point of view, we also continue to advise clients to complete their analyses of their structures, investor bases and operations, in order to be able to react promptly as clarity emerges, because the one thing that is clear is that the impact of the Directive will be very material and the timeframe affected firms will have to deal with all the changes the Directive will impose on them is unlikely to be generous.

If you would like to discuss any of the areas covered in this paper as well as the implications for your business, please speak with your local PricewaterhouseCoopers contact or one of our AIFMD specialists listed below:

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