Managed Funds Association White Paper

on the

Proposed EU Directive on Alternative Investment Fund Managers

September 21, 2009

Executive Summary

On 30 April 2009, in reaction to the global financial crisis and ongoing policy discussions taking place at the international level, the Commission of the European Communities (the "European Commission") published its "*Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers*" (the "Proposed Directive"). As currently drafted, the Proposed Directive would affect the operations of all investment managers that are not exclusively managing funds established under the Undertakings for Collective Investment in Transferable Securities Directive (Council Directive 85/611/EEC) as amended (the "UCITS Directive"), unless they qualify for one of the limited exemptions provided under the Proposed Directive.

This White Paper discusses the terms of the Proposed Directive and identifies provisions in the Proposed Directive that the Managed Funds Association ("MFA") believes will interfere with efficient market practices, adversely affect the ability of alternative investment fund managers ("AIFMs") to provide vital services to investors and limit the available choices and the potential benefits to European Union ("EU") investors who seek to invest in alternative investment funds ("AIFs").

MFA has identified the following provisions, among others, as problematic for the reasons set out below:

1. The Proposed Directive prohibits any AIFM which is neither authorised under the Proposed Directive nor authorised in accordance with the national law of a Member State from providing management services to any AIF domiciled in the EU. Since the Proposed Directive does not permit a non-EU AIFM to seek authorisation under the Proposed Directive, the Proposed Directive effectively prohibits a non-EU AIFM from providing management services to an AIF domiciled in the EU. We do not believe that this restriction is in the interests of investors or promotes the competitiveness of EU AIFs in the global marketplace.

2. The Proposed Directive includes a limited power for AIFMs to delegate portfolio management and/or risk management functions to another AIFM (including an affiliate) but only when the entity which has been delegated to is authorised as an AIFM to manage AIFs of the same type. This restriction excludes non-EU domiciled AIFMs and the operations of many AIFMs with global operations and is more restrictive than the rules applicable to retail funds (UCITS).

3. The Proposed Directive would require that, with respect to any side letters, the existence, contents and related investor identity would be required to be disclosed to other investors prior to their investment. This would apply regardless of whether the terms of existing side letters are material or not. We accept that an AIF should disclose to its investors that it (or the AIFM on its behalf) has the authority to enter into side letters and that the terms of side letters that are material to other investors in an AIF should be periodically disclosed to those investors. We disagree, however, with requiring the disclosure of non-material side letter terms. We also believe that the identity of investors in funds should not be required to be disclosed to other investors. Disclosure by an AIF that it (or the AIFM on its behalf) is authorised to enter into side letters and periodic disclosure of material terms in side letters should be sufficient to

enable other sophisticated investors to assess the potential impact of side letters on their investment.

4. The Proposed Directive would require the implementation of risk management systems that separate the risk management function from the portfolio management functions. We agree that AIFMs should implement risk management systems, but separation of risk management from portfolio management should not be mandated. Portfolio managers play a significant and integrated role in monitoring and analysing risk and portfolio management requires the use of appropriate risk analytics. A good alternative to the mandatory separation of these two functions would be a requirement for AIFMs to disclose to AIF investors the method by which risk management takes place.

5. The Proposed Directive requires that an AIFM ensure that the liquidity profile of each AIF it manages complies with that AIF's underlying obligations. Regular stress tests must be carried out and there must be a redemption policy appropriate to the liquidity profile of its investments. The MFA is concerned that the Proposed Directive is overly rigid and would unduly restrict investment options available to AIFMs.

6. MFA believes the capital adequacy requirements imposed by the Proposed Directive may be a barrier to entry for new AIFMs and the requirements do not take in account that many of the risks associated with the management of an AIF are borne by contract by the AIFs and not the AIFMs.

7. The Proposed Directive requires AIFMs regularly to disclose detailed information regarding levels of leverage to investors and home Member State regulators. The Proposed Directive states that one of its objectives is to enhance transparency of AIFM activity, including the systematic use of leverage, to enable the effective monitoring of systemic risks. MFA believes that there should not be regulatory restrictions on the use of leverage outside of the context of systemic risk regulation and that any restrictions on the use of leverage should be applicable to all systemically relevant market participants, including banks.

8. The Proposed Directive requires that a valuator and a depositary be appointed for each AIF and these must be independent of the AIFM and domiciled in an EU Member State or, for a non-EU AIF, a jurisdiction meeting certain specific requirements. With respect to non-EU valuators, the European Commission must have determined that the valuation standards and rules used by valuators established in the non-EU valuator's home jurisdiction are equivalent to those applicable in the EU. With respect to non-EU sub-depositaries:

- The European Commission must have determined that sub-depositaries domiciled in the non-EU sub-depositary's home jurisdiction are subject to effective prudential regulation and supervision which is equivalent to the provisions laid down in European Community law;

- Co-operation between the home Member State and the relevant authorities of the non-EU sub-depositary's home jurisdiction must be sufficiently ensured; and

- The European Commission must have determined that the standards to prevent money laundering and terrorist financing applicable to the non-EU sub-depositary are equivalent to those laid down in European Community law.

MFA believes these requirements may have the effect of reducing the number of available service providers, thus potentially increasing systemic risk with respect to the remaining small number of available providers.

9. The Proposed Directive imposes a three year transitional period during which non-EU AIFs may not be marketed in the EU under the proposed passport regime. It is unclear how the proposed three-year delay in providing a simpler uniform private placement regime benefits EU investors or improves the functioning of the EU market.

10. Three years after the implementation of the Proposed Directive, non-EU AIFMs would be permitted to seek authorisation under the Proposed Directive to market AIFs in the EU, provided all of the following requirements are satisfied:

- The European Commission must have determined that the country of domicile of the non-EU AIFM has adopted legislation regarding prudential regulation and on-going supervision which are equivalent to those under the Proposed Directive and such legislation is effectively enforced;

- The European Commission must have determined that the country of domicile of the non-EU AIFM grants EU AIFMs effective market access comparable to that granted by the European Community to AIFMs from the country of domicile of the non-EU AIFM;

- The non-EU AIFM provides the information required by Articles 5 and 31 to the regulator in the Member State in which it applies for authorisation;

- There is a co-operation agreement in place between the host Member State and the third country to ensure the efficient exchange of all information that is relevant for monitoring the potential implications of the activities of the AIFM for the stability of systemically relevant financial institutions and the orderly functioning of markets in which the AIFM is active; and

- The country where the non-EU AIFM is domiciled has signed an agreement with the Member State which complies with the standards in Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information in tax matters.

It is unclear how any non-EU country could meet these requirements and therefore MFA believes that the Proposed Directive may effectively preclude all non-EU AIFMs from marketing under the Proposed Directive to European investors.

11. The Proposed Directive does not permit marketing to sophisticated or high net worth investors as is currently possible under many private placement exemptions in

individual Member States. The Proposed Directive does not provide any transitional or "grandfathering" provisions to address the status of existing AIF investors who are not "professional investors".

12. Similarly, the Proposed Directive does not contain any transitional or "grandfathering" arrangements for existing contractual arrangements with non-EU AIFMs and other service providers.

13. The Proposed Directive requires an AIFM to make certain disclosures when one or more of its AIFs acquire 30% or more of the voting rights in a listed or unlisted company. The AIFM would be required to disclose several items – its development plan, the policy for preventing and managing conflicts of interest, and the policy for external and internal communication of the issuer – to the issuer, its shareholders and employee representatives. MFA believes that the Proposed Directive should not single out activities of AIFMs and AIFs for regulation of market-wide issues when other types of market participants acquiring similarly large stakes in listed or unlisted companies are not subject to the same blanket requirements, as such restrictions would have an anti-competitive impact on AIFMs and AIFs.

14. The Proposed Directive is silent as to the confidential treatment of proprietary information provided by AIFMs to regulators under the requirements of the Proposed Directive.

AIFMs and AIFs play a significant role in the economy by helping pension plans and other institutional investors achieve their financial goals, providing liquidity, reducing the volatility of market cycles, and providing access to capital for businesses of all sizes and types, especially where credit is limited from other sources.

The issues raised in this White Paper are of significant importance to MFA and its members inside and outside the EU. We appreciate the efforts of the European Commission in developing a thoughtful framework for the regulation of AIFMs. We look forward to working with EU officials and representatives as they work further to refine this framework.

White Paper
on the
Proposed EU Directive on Alternative Investment Fund Managers[1]

I. Introduction

Reacting to the global financial crisis and building on the ongoing discussions at an international level through the work of the G-20,[2] the International Organization of Securities Commissions ("IOSCO") and the Financial Stability Board, the Commission of the European Communities (the "European Commission") on 30 April 2009 published its "*Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers*" (the "Proposed Directive").

The Proposed Directive calls for, among other things, the establishment of an authorisation and supervisory regime for alternative investment fund managers ("AIFMs") domiciled both inside and outside the European Union (the "EU"). If adopted in its current form, the Proposed Directive would affect the operations of all investment managers that are not exclusively managing funds established under the Undertakings for Collective Investment in Transferable Securities Directive (Council Directive 85/611/EEC) as amended (the "UCITS Directive"), unless they qualify for one of the limited exemptions provided under the Proposed Directive.

MFA supports efforts to develop an effective and efficient regulatory system and the goals of reducing systemic risk, promoting investor protection and protecting the stability of the financial system. Nonetheless, MFA respectfully suggests that the current version of the Proposed Directive would interfere with efficient market practices, adversely affect the ability of AIFMs to provide vital services to investors and limit the available choices and the potential benefits to EU investors who seek to invest in alternative investment funds ("AIFs"). This White Paper identifies several provisions that raise concerns regarding the scope and requirements of the Proposed Directive.

The Proposed Directive includes a variety of substantive provisions that would adversely affect the way in which many AIFMs and AIFs operate. The Proposed Directive would, among other things:

1. discriminate against non-EU AIFMs with respect to the ability to market AIFs in the EU and to manage (or sub-manage) EU AIFs;

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[1] Dechert LLP prepared this White Paper for Managed Funds Association ("MFA"). MFA is the voice of the global alternative investment industry. MFA's members include professionals in hedge funds, fund of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world that manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington D.C. with an office in New York, New York.

[2] *E.g.*, G-20, Declaration on Strengthening the Financial System – London, 2 April 2009, available at http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf.

2. require an EU AIFM to seek authorisation from its home Member State regulator before a third party fund service provider is appointed and make the EU AIFM responsible for some aspects of the activities of certain third party fund service providers such as custodians and administrators in a way that may be inconsistent with the organisational structures of the AIFs for which they provide investment management services;

3. limit the options available to depositaries with respect to sub-delegation to other depositaries, creating significant (or insurmountable) difficulties for AIFs that employ global or emerging markets investment strategies;

4. discriminate against AIFMs, administrators and depositaries with operations outside the EU by limiting the ability to delegate to non-EU AIFMs, administrators and depositaries;

5. impose restrictions on the level of leverage that AIFs and AIFMs may use; and

6. increase the level of regulatory capital an EU AIFM is required to maintain.

We welcome the chance to discuss the issues raised in this White Paper with appropriate EU officials and representatives and all interested parties. We seek to provide assistance in achieving the European Commission's stated goal of ensuring regulatory and supervisory convergence of the rules applying to AIFMs and avoiding regulatory overlap. We would urge officials in both the EU and the United States at this historic time to work together to create laws and rules that lead to greater international harmonisation of regulation, enhanced economic stability, and vibrant investment opportunities, avoiding where at all possible discrimination among AIFMs and AIFs based on where they are organised or have operations. Because the alternative investment fund industry is a global industry, with AIFMs and AIFs organised and operating in many different countries employing many different structures, we also look forward to assisting EU officials and representatives in gaining a greater understanding of the industry as it currently exists to help avoid regulation that will unduly restrict the industry worldwide.

II. Regulation of Alternative Investment Fund Managers

A. Scope

(1) Covered AIFMs

The Proposed Directive would require an AIFM established in the EU to be authorised[3] under the Proposed Directive if the AIFM provides "management services" to any AIF, regardless of: (i) where the AIF is domiciled; (ii) how the AIF is structured; and (iii) whether the AIFM provides services to the AIF directly or by delegation.[4]

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[3] See section II.B. of this White Paper for a discussion of the authorisation regime.

[4] Article 4(1) of the Proposed Directive, first paragraph.

The Proposed Directive prohibits any AIFM which is neither authorised under the Proposed Directive nor authorised in accordance with the national law of a Member State from providing management services to any AIF domiciled in the EU.[5] Since the Proposed Directive does not permit a non-EU AIFM to seek authorisation under the Proposed Directive for purposes of managing an EU AIF, the Proposed Directive effectively prohibits a non-EU AIFM from providing management services to an AIF domiciled in the EU.[6] We do not believe that this restriction is in the interests of investors or promotes the competitiveness of EU AIFs in the global marketplace.

The Proposed Directive does exempt certain AIFMs from the requirement to be authorised and comply with the other provisions of the Proposed Directive, including:

1. Any AIFM that manages portfolios of AIFs whose assets under management, including assets acquired through the use of leverage, in total do not exceed a threshold of €100 million. The applicable threshold is increased to €500 million if the portfolio of AIFs consists of AIFs that are not leveraged and have no redemption rights exercisable during a period of five years following the date of constitution of each AIF. When calculating the threshold amount, an AIFM is deemed to manage any AIF managed by an entity with which the AIFM is linked by common management or control or by a substantive direct or indirect holding.

2. Any EU AIFM that does not provide management services to AIFs domiciled in the EU and does not market AIFs, regardless of domicile, in the EU. Given that the definition of marketing includes non-solicited as well as solicited activity an AIFM seeking to rely on this exemption would need to divest itself of all marketing responsibilities.

3. Any investment manager authorised under the UCITS Directive.

4. Banks, insurers and occupational pension funds.[7]

(2) <u>Definition of Management Services</u>

The Proposed Directive would only apply to an AIFM if it provides "management services", which is defined as "managing <u>and</u> administering" (emphasis added).[8] The Proposed

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[5] Article 4(1) of the Proposed Directive, second paragraph.

[6] *See* Article 5 of the Proposed Directive, which requires an AIFM to apply for authorisation in the Member State where the AIFM has its registered office and to have its head office in the Member State where it has its registered office. *See also* Article 18(1) of the Proposed Directive, which permits delegations of portfolio management and/or risk management only to third parties authorised as an AIFM to manage an AIF of the same type. These provisions together appear to prohibit a non-EU AIFM from managing an EU AIF directly or by delegation from an EU AIFM.

[7] Article 2(2) of the Proposed Directive.

[8] *See* Article 2(1) and Article 3(d) of the Proposed Directive.

Directive does not specify, however, what sort of activities constitute "managing" and what sort of activities constitute "administering". The conjunctive "and" implies that an AIFM must be doing both in order to be providing management services. Thus it is not clear whether the Proposed Directive will apply to an AIFM that provides only portfolio management services and does not provide administrative services. Many EU AIFs currently appoint an investment manager to manage the investment portfolio and an independent administrator to provide administrative services. It is relatively uncommon for an EU AIFM to provide administrative services.[9]

(3) <u>Definition of Alternative Investment Fund (AIF)</u>

The authorisation requirement of the Proposed Directive would only apply if the AIFM provides management services to an AIF, which is defined as a "collective investment undertaking" that is not subject to authorisation under the UCITS Directive.[10] Because hedge funds, private equity funds, real property funds, non-UCITS retail open-end funds and closed-end funds are not required to be authorised under the UCITS Directive, those types of funds would be considered AIFs under the terms of the Proposed Directive.

The broad definition of AIFs in the Proposed Directive contributes to the fact that there are few distinctions among the types of AIFs when it comes to the applicability of the substantive requirement of the Proposed Directive. While we support the concept of a comprehensive requirement for authorisation for AIFMs in principle and as a general matter, we also support the concept that the substantive requirements applicable to authorised AIFMs should differ, as appropriate, depending on the types of AIFs to which the AIFMs provide management services. We would encourage the EU to consider carefully the differences among the types of AIFs to tailor the requirements applicable to AIFMs managing different types of AIFs to avoid adopting regulations that will have a disproportionate adverse impact on certain portions of the industry.

B. Authorisation Generally

Authorisation under the Proposed Directive would involve the AIFM applying for authorisation from the regulator in the Member State where the AIFM has its registered office (the "home Member State regulator"). Part of the application process would require the AIFM to identify the AIFs it manages and the strategies it uses and provide information about the applicable valuators, depositaries and any entities to which the AIFM intends to delegate. The home Member State regulator has up to two months to review the application and to inform the AIFM if the application has been granted.[11]

Once the home Member State regulator grants authorisation, the Proposed Directive would require the AIFM to notify its home Member State regulator of any change in

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[9] Industry practice in other jurisdictions vary.

[10] Article 3(a) of the Proposed Directive.

[11] Article 5 of the Proposed Directive.

investment strategy and policy of any AIFs it manages, changes in constitutional documentation, etc.[12] The home Member State regulator would then have up to a month to approve or reject such changes to the scope of the AIFM's authorisation or to impose restrictions.[13] This one month delay, while the home Member State regulator reviews the materials that have been submitted by the AIFM (and any additional time required thereafter for the AIFM to make any adjustments required by the home Member State regulator) could substantially delay the launch of new AIFs or delay the effectiveness of changes to the terms of existing AIFs, which could have a serious commercial impact in respect of lost investment opportunities and inflexibility in dealing with unexpected market changes or other emergencies.

Typically, investor approval is required before significant changes to key aspects of an AIF's terms can be made. At best the Proposed Directive's requirement adds to the required lead time for changes to be made; at worst, however, it may substitute the judgment of the home Member State regulator for that of the AIF's investors who are all sophisticated investors and are best suited to make decisions about changes to an AIF's terms.

A non-EU AIFM that wants to become authorised to manage EU AIFs could establish a subsidiary domiciled and having its registered office in one of the Member States and that subsidiary could apply to become an authorised AIFM. Unfortunately, this effort would be of limited utility since the subsidiary, as an AIFM authorised under the Proposed Directive, would not be permitted to delegate portfolio management or risk management functions to a non-EU AIFM, including its non-EU parent, as discussed in detail below.

C. Delegations of Portfolio and Risk Management

The terms of the Proposed Directive require an authorised AIFM to seek authorisation from its home Member State regulator to delegate portfolio management and/or risk management functions to another AIFM, including an AIFM that is an affiliate, and to meet the general conditions for delegation.[14] Any entity to which an AIFM seeks to delegate portfolio management and/or risk management must also be authorised as an AIFM to manage an AIF of the same type.[15] This means that delegations may not be made to non-EU domiciled AIFMs or

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[12] *Id.*

[13] *Id.*

[14] *See* Article 18(1) of the Proposed Directive. Article 18(1) of the Proposed Directive imposes a number of general conditions which must be met for all delegations:

1. The delegate must be creditworthy and the persons conducting the delegate's business must be sufficiently experienced and of sufficiently good repute;
2. The delegation cannot prevent the effectiveness of the supervision of the AIFM or prevent the AIFM from acting, or the AIF from being managed, in the best interests of its investors; and
3. The AIFM must demonstrate that the delegate is qualified and capable of performing the functions being delegated, the delegate was selected with due care and the AIFM is in a position to monitor effectively the delegated activities, provide further instructions to the delegate and terminate any delegation with immediate effect when this is in the interest of investors.

[15] Article 18(1)(b) of the Proposed Directive.

non-EU domiciled affiliates since such entities would not be allowed to be authorised under the Proposed Directive to manage EU AIFs.[16]

Ultimately the Proposed Directive permits a very limited power of delegation. For many asset management firms, especially asset management firms with portfolio and risk management operations in multiple jurisdictions around the world, this limited power of delegation, at best, will increase portfolio management costs, which costs will likely be passed on to investors and, at worst, will effectively prevent EU AIFs from being managed by many global AIFMs.

Many large investment managers (whether of UCITS funds or AIFs) and some smaller ones are increasingly looking to provide investment management services in or close to the markets in which they are investing. This allows the investment manager to operate more effectively, access broker services and exchanges in real time, and often provide better expertise and market access to investors. EU AIFs and EU investors may suffer as they will no longer be able to access local portfolio management talent to invest in, for example, the Americas or Asia.

Similarly it is not uncommon for a non-EU AIFM to want to delegate portfolio management responsibility in respect of one or more non-EU AIFs to an EU AIFM. While such a delegation would not be prohibited under the Proposed Directive, the fact that delegating portfolio management responsibility to the EU AIFM would require that the EU AIFM ensure that the AIF complies with the requirements related to, *inter alia*, valuators, depositaries, disclosure, leverage limitations, liquidity management requirements, etc. imposed by the Proposed Directive will reduce the global competitiveness of EU AIFMs. In the sub-advisory context, an EU AIFM typically will not have the ability to compel the AIF to comply with the requirements under the Proposed Directive. Therefore, it may not be possible in practice for an EU AIFM to sub-advise non-EU AIFs.

The Proposed Directive's limitations on delegation of portfolio management and risk management functions also provide an excess level of regulation over the limits of the UCITS Directive[17] and the MiFID Directive,[18] both of which allow an investment manager to

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16 See discussion at footnotes 5 and 6 above.

17 Article 21 of the UCITS Directive provides that the management or investment company must employ a risk management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio.

Portfolio management may be delegated to a third party under the UCITS Directive. However management companies will retain full responsibility for the effectiveness and appropriateness of the risk management process involved in the management of the fund's portfolio, and should take all necessary steps to ensure that the delegate is able to carry out the delegated activities reliably and effectively and in compliance with applicable laws and regulatory requirements. The management or investment company will still need to be able to supervise the delegated activities and should establish procedures for the periodic assessment of the delegate's activities insofar as they impact on the portfolio management. Article 5(g) of the UCITS Directive does not exclude delegation to companies organised outside of the EU.

18 Directive 2044/39/EC of the European Parliament and of the European Council of 21st April 2004 (the "MiFID Directive"). Under the MiFID Directive, portfolio management functions are permitted to be outsourced to service providers located in third countries provided certain conditions are met. These

delegate portfolio management functions to investment managers in non-EU jurisdictions as long as the arrangement meets the relevant conditions. Since AIFs may only be marketed to professional investors and UCITS may be marketed to retail investors, there does not appear to be a good investor protection based argument in favour of imposing higher standards in this regard for AIFs.

D. Substantive Requirements for Authorised AIFMs

The Proposed Directive includes some fairly universal best practices as mandatory requirements for authorised AIFMs, including the duty to:

1. Act honestly, with due skill, care and diligence and fairly in conducting its activities;[19]

2. Act in the best interest of the AIF, its investors and the integrity of the market[20] (although the possible conflict between these three requirements needs to be understood and, preferably, dealt with at this stage);

3. Ensure AIF investors are treated fairly;[21]

4. Identify and manage conflicts of interest;[22] and

5. Operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the interest of the AIF and its investors.[23] (We note, however, that the addition of the word 'all' here may be a step too far).

The Proposed Directive also contains a variety of other substantive requirements that we believe are unnecessary and would be overly burdensome, however, including the following:

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include: (i) responsibility for performance must remain with the delegator's management; (ii) a service level agreement must be in place between the parties; and (iii) the delegator must exercise due skill, care and diligence when entering into, managing or terminating any arrangement for the outsourcing to a service provider of critical or important operational functions or of any investment services or activities. Additional requirements are levied on third country service providers where portfolio management is provided to retail clients.

[19] Article 9(1)(a) of the Proposed Directive.

[20] Article 9(1)(b) of the Proposed Directive.

[21] Article 9(1)(c) of the Proposed Directive.

[22] Article 10 of the Proposed Directive.

[23] *Id*.

(1) Side Letters

The Proposed Directive requires that no investor may obtain a preferential treatment unless this is disclosed in the AIF's rules or instruments of incorporation.[24] The Proposed Directive also requires that if an investor obtains preferential treatment or the right to obtain it, the identity of that investor and a description of the preferential treatment must be disclosed to other investors prior to their investment.[25] Neither of these requirements includes any concept of materiality. As a result, the Proposed Directive would require that even non-material terms of side letters be disclosed and that an investor's identity be compromised.

Many side letters contain non-material terms required by investors who have their own specific requirements for investments in AIFs but which other investors do not want or need. Side letters are a useful tool for providing flexibility to invest for these investors with special requirements, allowing the investment to be tailored so that the investor may invest. Without this flexibility, some investors would face a very limited universe of AIF investment choices.

We understand that an AIF should disclose to its investors that it (or the AIFM on its behalf) has the authority to enter into side letters and that the terms of side letters that are material to other investors in an AIF should be periodically disclosed to those investors. We disagree, however, with the approach of requiring the disclosure of non-material side letter terms. We also believe that the identity of investors in AIFs should not be required to be disclosed to other investors, as the identity of an investor that has special needs is not necessary to enable other investors to assess the impact of any side letter on their investment and may run contrary to applicable data protection or privacy laws. Disclosure by an AIF that it (or the AIFM on its behalf) is authorised to enter into side letters and periodic disclosure of material terms in side letters should be sufficient to enable other investors to assess the potential impact of side letters on their investment.

(2) Risk Management

While we agree that AIFMs should implement risk management systems, there are two aspects of the proposed risk management requirements in the Proposed Directive that we suggest be reconsidered: (i) the mandatory requirement to separate risk management from portfolio management (discussed in this section);[26] and (ii) the risk management requirements related to the use of short sales (discussed in the next section).[27]

We believe that portfolio management neither can nor should be entirely separated from risk management. Appropriate management of market risk, portfolio risk,

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[24] Article 9(1) of the Proposed Directive.

[25] Article 20(1)(i) of the Proposed Directive.

[26] Article 11(1) of the Proposed Directive.

[27] Article 11(4) of the Proposed Directive.

liquidity risk, etc. requires the active involvement of portfolio management personnel. Portfolio managers have a significant and integrated role in monitoring and managing the risk. Moreover, portfolio management requires the use of appropriate risk analytics. We believe there should be a balance that allows for appropriate participation of portfolio management personnel.

The Proposed Directive is unclear regarding whether an AIFM could have a risk management function that involves input (substantial or otherwise) from portfolio management personnel. For some small or start up AIFMs, it may not be possible to comply with the mandatory requirement to separate risk management from portfolio management without adding staff, which will discourage new entrants to the market, thereby reducing overall employment opportunities in the industry and reducing choice for investors. A good alternative to the mandatory separation of functions would be a requirement for the AIFM to disclose to AIF investors the method by which risk management takes place.

The Proposed Directive also provides that the European Commission must adopt measures that specify the risk management requirements to be employed by AIFMs.[28] It is not clear what this requirement would entail, but we do not believe that the European Commission should dictate how an AIFM should manage risk (as opposed to requirements that an AIFM has and discloses reasonable risk management policies that address areas of risk such as market risk, operational risk, etc.). Investors should be allowed to choose an AIF based on disclosure regarding how an AIFM identifies and manages the risks the manager takes in managing the AIF. Portfolio managers are naturally incentivised to identify and manage risk well -- if they do not manage risk well investors will leave their AIF and the portfolio manager's reputation would be damaged. Moreover, portfolio managers frequently invest their own money in the AIFs they manage aligning their interests with the interests of investors when it comes to managing risk.

(3) <u>Short Selling</u>

The Proposed Directive would require the European Commission to adopt implementing measures to specify "any arrangements needed to enable AIFM to manage the particular risks associated with short selling transactions, including any relevant restrictions that might be needed to protect the AIF from undue risk exposures."[29] The focus on short selling in this requirement is problematic for two reasons:

1. The short selling requirements in Article 11 appear to single out short selling by authorised AIFMs on behalf of AIFs for special regulatory scrutiny and limitations; and

2. It implies that short selling, more than any other risk associated with other types of investment transactions, requires special risk management arrangements mandated by regulation.

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[28] Article 11(5)(a) of the Proposed Directive.

[29] Article 11(5)(b) of the Proposed Directive.

Consistent with the European Commission's statements regarding the regulation of market-wide issues,[30] any limitations on the use of short selling or delivery requirements should be applied to all market participants, outside the context of the Proposed Directive or AIFs receiving management services from authorised AIFMs will be at a competitive disadvantage. Any regulation of short selling should also provide a level playing field whether an investor receives services by way of an AIF, a segregated account or any other type of structure or entity.

In considering how best to implement short selling and other regulations, it is important to make sure that regulators have the resources, including staff with sufficient experience and expertise, to meet those obligations. In seeking to achieve this goal, it may be appropriate to address certain issues at the EU or European Commission-level and to address other issues at the national level, with a focus on greater coordination and harmonisation by national policy makers and regulators.

(4) Liquidity Management

The Proposed Directive requires an AIFM to employ an appropriate liquidity management system with respect to each AIF it manages and to adopt procedures to ensure that the liquidity profile of the AIF's investments complies with the AIF's underlying obligations. The Proposed Directive also requires the AIFM to conduct regular stress tests and to ensure that each AIF has a redemption policy that is appropriate to the liquidity profile of its investments.[31]

We are concerned that the proposed requirement that an AIFM has procedures "which ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations"[32] (emphasis added) imposes a standard that is too strict. Procedures should be reasonably designed to achieve a purpose; they do not, and can not, ensure that purpose is achieved.

AIFMs often manage the liquidity of the investment portfolios of their AIFs over a period of time, usually several years, and seek to manage the general liquidity profile of the portfolios in a manner that is consistent with the obligations of the respective AIF over time, but this is not necessarily the same as matching the liquidity of the AIF to its obligations. An overly rigid requirement to match an AIF's redemption terms to the liquidity of its investment portfolio would unduly restrict investment options for AIFMs. For example, an AIFM may be required to hold excess levels of cash and cash equivalents in the portfolio to hedge against possible redemptions and the possibility that unexpected market events may change the liquidity profile of the AIF's investments, leaving the portfolio less than fully invested which may adversely affect the risk/return profile that investors expect from the AIF.

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[30] Frequently Asked Questions produced by the European Commission on 29 April 2009 (MEMO/09/211), available at http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/211&format=HTML&aged=0&language=EN&guiLanguage=fr.

[31] Article 12(1) and Article 12(2) of the Proposed Directive.

[32] Article 12(1) of the Proposed Directive.

The Proposed Directive also provides that the European Commission shall adopt implementing measures to further specify the liquidity management requirements that will apply and, in particular, the minimum liquidity requirements for AIFs which redeem units or shares more often than half yearly.[33] By their very nature, any such requirements will be somewhat arbitrary and will need to be "one size fits all" as it will be necessary to define broadly when an investment is liquid (which will differ among asset classes). Moreover, as market conditions change, any such requirements may quickly become too restrictive or otherwise inappropriate. The practical effect of these provisions is to regulate investment policies of AIFs. This is something that the Frequently Asked Questions produced by the European Commission on 29 April 2009 (MEMO/09/211) state that the Proposed Directive should not do: "Regulation of investment policies would be unnecessarily restrictive given the professional nature of the investor base and would be impractical to implement given the diversity of business models."

(5) <u>Initial and Ongoing Capital</u>

The Proposed Directive would require each AIFM to maintain at least €125,000 as capital for the purpose of ensuring that the AIFM has an appropriate amount of capital available to meet its obligations as they become due. Where the value of the portfolios of AIFs managed by an AIFM exceeds €250 million, the Proposed Directive would require an AIFM to maintain an additional amount of capital equivalent to 0.02% of the amount by which the value of the portfolios of the AIFM exceeds €250 million. For purposes of this calculation, the applicable portfolios will include any AIFs managed by the AIFMs (including AIFs for which the AIFM has delegated to another AIFM) and any AIF portfolios that the AIFM manages under delegation.[34]

An initial capital requirement at this level may be a barrier to entry for new AIFMs. In addition, this formula for capital adequacy uses a "one size fits all" approach that does not consider whether the actual obligations of the AIFM necessarily increase as assets under management increase. Moreover, unlike the capital requirements for banks, which mandate capital requirements on the basis of a formula that scores the risks to which the bank is subject, the capital requirements to be imposed on AIFMs would not be geared to the AIFMs' risks or expense obligations. The capital requirement also fails to take into account that many of the risks associated with the management of an AIF are borne by contract by the AIF and not the AIFM. For example, there is counterparty risk associated with the management of an AIF, but the obligations to the counterparty are typically owed by the AIF out of the assets of the AIF rather than by the AIFM.

E. Leverage

The Proposed Directive requires an AIFM that manages one or more AIFs that employ high levels of leverage on a systematic basis (*i.e.,* combined leverage from all sources exceeds the value of the equity capital of the AIF in two out of the past four quarters) to make certain disclosures to investors and to the AIFM's home Member State regulator. The assessment

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[33] Article 12(3) of the Proposed Directive.

[34] Article 14 of the Proposed Directive.

of whether an AIF employs high levels of leverage on a systematic basis must be done on a quarterly basis.[35]

An AIFM that manages one or more AIFs meeting the leverage criteria must disclose to investors in each such AIF:

1. The maximum level of leverage which the AIFM may employ on behalf of the AIF as well as any right of re-use of collateral or any guarantee granted under the leveraging arrangement; and

2. Quarterly, the total amount of leverage employed in the preceding quarter.[36]

An AIFM that manages one or more AIFs meeting the leverage criteria must also regularly disclose to its home Member State regulator the overall level of leverage employed by each AIF it manages and a breakdown between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives, including the identity of the five largest sources of borrowed cash or securities for each AIF managed and the amounts of leverage received from each of those entities for each AIF managed by the AIFM.[37] These disclosure requirements include the requirement to disclose information about any AIFs managed by the AIFM that do not themselves meet the criteria for employing a high level of leverage on a systematic basis.

The European Commission is permitted under the Proposed Directive to further specify disclosure requirements and frequency of reporting to authorities and investors, taking into account the type of AIFs, their strategies and their sources of leverage.[38] The European Commission is also required to adopt measures setting limits on the level of leverage an AIFM can employ, taking into account, *inter alia*, the type of AIFs, their strategies and the sources of their leverage.[39] This requirement is meant to ensure the stability and integrity of the financial system, but it focuses on a limited group of market participants. In addition, home Member State regulators may impose additional temporary limits on leverage to ensure stability and integrity of the financial system.[40]

The Explanatory Memorandum that prefaces the text of the Proposed Directive posits that "[t]he abrupt unwinding of large, leveraged positions in response to tightening credit conditions and investor redemption requests has had a procyclical impact on declining markets and may have impaired market liquidity." Studies have shown the hedge fund industry was not

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[35] Article 22 of the Proposed Directive.

[36] Article 23 of the Proposed Directive.

[37] Article 24(1) of the Proposed Directive.

[38] Article 24(2) of the Proposed Directive.

[39] Article 25(3) of the Proposed Directive.

[40] Article 25(4) of the Proposed Directive.

highly leveraged leading into the recent market crisis, particularly compared with other financial institutions like banks and broker-dealers.[41] In fact, hedge funds will often seek to invest in ways that reduce the potential volatility of the market cycle. This misconception about the amount of leverage used by AIFs and the potential systemic risk concerns regarding the use of leverage appears to carry over to the text of the Proposed Directive.

Because the Proposed Directive sets the threshold for what constitutes a high level of leverage on a systematic basis at the level of one times capital,[42] we believe that the authority granted to set leverage restrictions is overly broad. We also strongly disagree with the notion that leverage of 1 times capital (a 2-to-1 leverage ratio) is systematically high, or raises systemic risk concerns.

The stated objective of the Proposed Directive to which this requirement relates is the "proper monitoring of macro-prudential risks" and the related operational objective is phrased as "enhance transparency of AIFM activity, including the systematic use of leverage, to enable the effective monitoring of systemic risks". Any strict limitation on the maximum amount of leverage an AIFM may employ seems to exceed the stated objective of transparency. Such a limitation acts as regulation of investment policies because it would likely preclude or greatly limit the ability to engage in certain strategies (*e.g.,* certain arbitrage strategies). This type of regulation of investment policies is contrary to the stated scope of the Proposed Directive as expressed in the European Commission's Frequently Asked Questions (MEMO/09/211). Any leverage limitations imposed will be somewhat arbitrary and will need to be "one size fits all". As market conditions change, any such requirements may quickly become too restrictive or otherwise inappropriate.

We do not believe that there should be regulatory restrictions on the use of leverage outside of the context of more general systemic risk regulation affecting systemically relevant market participants, including banks. The potential systemic risks posed by the use of leverage are not specific to AIFMs. As a result, systemic risk regulation regarding leverage should not be focused on AIFMs and AIFs, but should be considered across market participants. In this same vein, setting leverage restrictions specific to AIFMs is also inconsistent with another of the stated purposes of the Proposed Directive, as explained in the European Commission's frequently asked questions regarding the Proposed Directive, which states:

> This proposal focuses on those activities that are specific or inherent to the AIFM sector and hence need to be addressed by targeted requirements. A number of the concerns that are commonly expressed about the activities of AIFM are linked to behaviours (*e.g.*, short-selling, and remuneration) which are not unique to this category of financial market participants. To

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[41] *See*, *e.g.*, "*The future of financial regulation – Insights from a regulator*", speech by Dan Waters, FSA Asset Management Sector Leader, at the FSA International Forum, Monaco on 24 June 2009, published at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0624_dw.shtml. The Turner Review – A regulatory response to the global banking crisis (the "Turner Report"), pages 72, 73. The Turner Report is available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

[42] Article 22 of the Proposed Directive.

be fully effective and coherent, these concerns must therefore be addressed by comprehensive measures which apply to all market participants who engage in the relevant activities.

F. Valuators

Under the Proposed Directive, the AIFM must appoint an independent valuator (independent of the AIFM, the AIF and any administrator to whom administrative services have been delegated by the AIFM) for every AIF it manages.[43] The role of the valuator would be to establish the value of assets acquired by the AIF and the value of the shares or units of the AIF, at least annually and each time there is an issue or redemption if this is more frequent than annually.[44] The valuator would be obliged to value the assets and calculate the net asset value based on the rules set out in the laws of the country where the AIF is domiciled or in the AIF's organisational documents.[45] An AIFM may only appoint a non-EU valuator if the valuator has been established in a country that has rules and standards for valuation that are judged by the European Commission to be equivalent to the EU requirements, including the requirements under the Proposed Directive.[46]

We do not believe that there should be a requirement for an AIFM to hire a third party valuation service provider. We believe that, particularly with respect to harder-to-value instruments, the personnel of the AIFM, and especially the portfolio manager, are likely to be in the best position to determine the fair value of those instruments. We support the implementation of robust internal policies and procedures regarding valuation and the maintenance of appropriate independence between the valuation and portfolio management functions. We believe that the total separation of the portfolio manager and other investment management personnel from the valuation process would be ill-advised and would ignore the expertise and market sophistication of the portfolio managers and other investment manager personnel.

A requirement for an independent valuator may give investors a false sense of assurance about the valuations placed on securities. A valuator may not be as well placed as an expert portfolio manager to know when a price received from a pricing service or counterparty does not reflect a fair price for the security. Without access to that expertise, portfolio securities may be significantly under- or over-valued, potentially disadvantaging some investors and providing a windfall to others.

As noted above, EU AIFs generally will engage an independent third party administrator to calculate the net asset value of an AIF and its shares or units in accordance with policies adopted by the governing body of the AIF and disclosed in the AIF's offering

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[43] Article 16 of the Proposed Directive. *See also* Article 18(1) of the Proposed Directive.

[44] Article 16(1) of the Proposed Directive.

[45] Article 16(3) of the Proposed Directive.

[46] Article 37 of the Proposed Directive.

documents. A requirement to engage a valuator would increase costs for these AIFs without any apparent gain in independence from the AIFM.

Because the valuator must be separate from (it would seem) the administrator and the AIFM and must act without substantive input from the AIFM in determining values, it is not clear that there are entities able, willing and qualified to carry out this function at present in any event.

Finally, the Proposed Directive speaks of AIFMs appointing "a valuator". It is not clear that an AIFM could engage more than one valuator with respect to a single AIF, which may be necessary or desirable depending on the types of assets held by the AIF. In any event, in an EU setting it is normally the AIF and not the AIFM that would appoint the person responsible for calculating net asset value.

G. Delegation of Administration Services by the AIFM

An AIFM may delegate the administrative services portion of its management services role to another entity subject to the general rules on delegation.[47] If an AIFM delegates the administrative services portion of its "management services" duties to a third party administrator, the AIFM would remain liable for any functions delegated to the administrator.[48]

The Proposed Directive permits an AIFM that manages an AIF to delegate administrative services outside the EU if the following additional conditions are met:

1. The delegate is authorised to provide administration services or is registered in the third country and subject to prudential supervision; and

2. There is an appropriate co-operation agreement between the third country and the home Member State regulator of the AIFM.[49]

If an AIFM wants to delegate administrative services to any entity, whether in the EU or outside the EU, the AIFM may only do so to an entity that does not also serve as the valuator.[50]

The Proposed Directive also needs to take account of and deal with the fact that, in the EU, AIFs (rather than AIFMs) typically appoint the administrator.

Some countries, including the United States, do not have a registration or authorisation process for fund administrators and even for those countries that do, it is not clear whether those countries impose the type of prudential supervision that is envisaged by the

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[47] Article 36 of the Proposed Directive. See footnote 14, *supra*, for a discussion of the general conditions for delegations.

[48] Article 18 of the Proposed Directive.

[49] Article 36 of the Proposed Directive.

[50] Article 18(1) of the Proposed Directive.

Proposed Directive. These requirements may limit the ability of non-EU AIFs to employ local administrators if they also employ an EU AIFM.

In addition, these requirements may ultimately limit the selection of available administrators or dramatically increase the costs of such services. Many large administrators have global operations where portions of the activities that are contracted for in the EU are delegated by the administrator to be performed outside the EU. Without this ability to delegate certain functions outside of the EU, which helps create economies of scale, the administrators' cost of doing business will increase and those costs can be expected to be passed along to investors. Administrators who are unable or unwilling to restructure their operations may not be able to continue to operate in the EU, decreasing the number of available administrators. This could have the further effect of reducing the number of available jobs in some places and causing skilled workers to need to relocate to find work.

H. Depositaries

Under the Proposed Directive, the AIFM must also appoint a depositary (*i.e.,* an authorised credit institution having its registered office in the EU) for every AIF it manages.[51] This depositary would be responsible, to the extent applicable, for the following tasks:

1. Receiving all subscription payments and booking them on behalf of the AIFM in a segregated account;

   Note: This requirement ignores the fact that many AIFs are organised in such a way that any subscription funds would be assets of the AIF and not the AIFM and would need to be booked on behalf of the AIF not the AIFM;

2. Safe-keeping any financial instruments which belong to the AIF; and

3. Verifying whether the AIF or the AIFM on behalf of the AIF has obtained the ownership of all other assets in which the AIF invests.[52]

Under the Proposed Directive, the depositary is obliged to act independently of the AIFM and solely in the interests of AIF investors.[53] Despite the fact that the investors in the AIF will have no privity of contract with the depositary, the depositary would be liable under the terms of the Proposed Directive to both the AIFM and the investors of the AIF (which liability may be invoked directly by investors or indirectly through the AIFM depending on the legal nature of the relationship among the depositary, the AIFM and the investors) for any losses suffered by them as a result of any failure on the part of the depositary to perform its obligations imposed under the Proposed Directive.[54] The depositary would only be able to avoid liability on

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[51] Article 17 of the Proposed Directive.

[52] Article 17(1) of the Proposed Directive.

[53] Article 17(2) of the Proposed Directive.

[54] Article 17(5) of the Proposed Directive.

the loss of any instruments in safe-keeping if it can affirmatively prove that it could not have avoided the loss that has occurred.[55] These requirements would create a situation where the depositary would be subject to semi-strict liability for the potential frauds and failings of other parties.

These requirements, especially the high standard of liability, will likely reduce the number of institutions willing to carry out this service and will lead to a significant increase in the costs that an AIF will have to bear: costs that will fall directly on investors through an increase in the AIF's total expense ratio. Moreover, the level of liability to which depositaries would be subject would no doubt force a change in the service level arrangements under which the depositary is willing to operate, thereby potentially limiting the ability of some AIFs to engage in transactions in some countries or engage in transactions with certain counterparties.

Under the Proposed Directive, depositaries have a fairly limited ability to delegate to other qualified depositaries and their liability to investors and the AIFM would not be affected by any delegation.[56] Moreover, a depositary can only delegate its functions to a non-EU depositary with respect to a non-EU AIF and then only to a depositary domiciled in the same non-EU country where the non-EU AIF was domiciled and even then only if:

4. The third country has EU equivalent prudential regulation and supervision;

5. Co-operation between the home Member State and the third country is assured; and

6. The Commission decides that third country is subject to EU-equivalent anti-money laundering standards.[57]

We are concerned that these limitations on sub-depositaries would make it difficult or even impossible for an EU-domiciled AIFM to manage an AIF with a global or emerging markets strategy and for any AIF with such an objective to be domiciled in the EU, since sub-depositaries around the world are typically used by AIFs not investing solely in the EU and are often required in order to operate a global or emerging markets strategy.

We are also concerned about the requirement to use an EU authorised depositary, particularly for non-EU AIFs. Certain types of AIFMs (*e.g.,* AIFMs for hedge funds) frequently maintain custody of the assets of their AIFs with their prime broker. We do not believe that the Proposed Directive should limit the ability of the AIF industry to continue using this custody model.

We believe that the requirement that depositaries be EU authorised credit institutions (in addition to the other requirements discussed above) inappropriately restricts the

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55 *Id*.

56 Article 17(5) of the Proposed Directive.

57 Article 38 of the Proposed Directive.

universe of available custodians. Indeed, restricting the number of custodians in this manner may increase systemic risk, as it would increase counterparty risk in the industry by limiting the number of available counterparties and increase the likelihood that a significant event at one credit institution will have a significant effect on the industry.

We note that the UCITS Directive does not impose similar geographic restrictions on the use of sub custodians for UCITS funds, reflecting the needs of the market.

Finally, the Proposed Directive speaks of AIFMs appointing "a depositary". There are two problems with this. First, the AIFM is often not the party responsible for the appointment of the depositary (the AIF is). Second, it is not clear that an AIFM could engage more than one depositary with respect to a single AIF which may be necessary or desirable depending on the types of assets held by the AIF. In the aftermath of the Lehman bankruptcy, it is not at all unusual for an AIF to employ more than one prime broker in order to reduce its counterparty risk and better safeguard its assets.

III. Regulation of Marketing of Alternative Investment Funds in the EU

A. Marketing by EU AIFMs

An AIFM domiciled in the EU and authorised under the Proposed Directive may market the EU AIFs and non-EU AIFs it manages to professional investors in the home Member State of the AIFM following submission to the home Member State regulator of a notification in respect of each AIF the AIFM intends to market. The home Member State regulator has ten days to review the notification and inform the AIFM whether it may start marketing the AIFs included in the notification. The Proposed Directive would allow the various home Member State regulators to impose restrictions or conditions on the marketing of AIFs by AIFMs governed by that Member State.[58]

An AIFM domiciled in the EU and authorised under the Proposed Directive may market the EU AIFs it manages to professional investors in another Member State within ten working days after a submission to the home Member State regulator of a notification in respect of each AIF the AIFM intends to market in another Member State pursuant to the passporting requirements under the Proposed Directive.[59]

Following a three year transitional period, an AIFM domiciled in the EU and authorised under the Proposed Directive would be able to market certain non EU-domiciled AIFs it manages to professional investors in another Member State within ten working days (or longer if such period is extended by the home Member State to allow a longer time to check if the conditions of the Proposed Directive have been met) after a submission to the home Member State regulator of a notification in respect of each AIF the AIFM intends to market in another country.[60] To qualify to be passported in this way, the AIF must be domiciled in a country that

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[58] Article 31 of the Proposed Directive.

[59] Article 33 of the Proposed Directive.

[60] Article 33 of the Proposed Directive.

has signed an agreement with the Member State where the marketing is to take place which complies with the standards in Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information on tax matters.[61]

MFA welcomes this simplification and rationalisation of the current private placement regime. However, we believe that access to the passporting regime should not be delayed for non-EU AIFMs. It is not clear how the three year delay improves the functioning of the EU market or is in the interests of EU AIFMs or investors.

B. Marketing by Non-EU AIFMs

As noted above, an AIFM domiciled outside the EU would not be permitted to become authorised under the Proposed Directive to provide management services directly to an EU AIF or indirectly by delegation with respect to any AIF managed by an authorised EU AIFM. Starting three years after the effective date of the Proposed Directive, an AIFM domiciled outside the EU would be permitted to seek authorisation from a Member State under the Proposed Directive for the purpose of marketing AIFs in the EU.[62] The Proposed Directive would permit a Member State to authorise a non-EU AIFM to market shares or units of the non-EU AIFs they manage to professional investors in the EU, provided:

1. The European Commission has determined that the country where the non-EU AIFM is domiciled has adopted legislation regarding prudential regulation and on-going supervision that is equivalent to the provisions of the Proposed Directive imposed on EU AIFMs that provide management services to AIFs (*e.g.*, the requirements related to valuators, depositaries and administrators, limits on leverage, liquidity management restrictions, etc.) and that the country effectively enforces its regulations;

2. The country where the non-EU AIFM is domiciled grants comparable effective market access to EU AIFMs;

3. There is a co-operation agreement in place between the Member State and the country where the non-EU AIFM is domiciled that ensures efficient sharing of information relevant for monitoring the potential implications of AIFM activities for the stability of systemically relevant financial institutions and the orderly functioning of markets in which the AIFM is active; and

4. The country where the non-EU AIFM is domiciled has signed an agreement with the Member State which complies with the standards in Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information in tax matters.[63]

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[61] Article 35 of the Proposed Directive.

[62] Article 39 and Article 54(1) of the Proposed Directive.

[63] Article 39(1) of the Proposed Directive.

It is not clear that any non-EU country would meet these requirements and, as a result, the Proposed Directive would effectively preclude a non-EU AIFM from marketing to European investors if the existing private placement exemptions under the national laws of the Member States were to be withdrawn by the respective Member States. In any event, it is not clear how the three year delay will help the EU market, AIFMs or investors.

If non-EU AIFMs are not permitted to market AIFs in the EU, EU investors will have many fewer AIFs to choose from and may be limited in their ability to spread risk. Additionally, EU investors may not be able to access the investment expertise of non-EU AIFMs. Moreover, to exclude non-EU AIFMs in this way is a clear contradiction of the commitment made by Finance Ministers and Central Bank Governors at the G-20 meeting on 14 March 2009 to "fight all forms of protectionism and maintain open trade and investment."[64]

C. Existing Private Placement Exemptions

During the three year transitional period applicable to marketing non-EU AIFs in the EU (whether managed by an EU AIFM or a non-EU AIFM), we would expect Members States to allow or continue to allow the marketing of AIFs in accordance with any private placement exemptions applicable under the national laws of that Member State, although it is not entirely clear under the terms of the Proposed Directive that this will be the case.

Because there are currently different private placement requirements applicable in different Member States, the benefit of the authorisation process and passporting is perceived to be a simplified and efficient process that eliminates legal and compliance uncertainty. Authorisation under the Proposed Directive would open marketing opportunities in certain jurisdictions where AIFMs are currently prohibited by national law from initiating offers of shares or units of AIFs to investors in those countries and investors in such countries may only invest in AIFs through a process of reverse enquiry (*i.e.*, the initiative comes from the investor rather than the AIF or the AIFM). However, authorisation under the Proposed Directive could restrict marketing in other countries (such as the United Kingdom) where current national laws permit marketing to a universe of potential investors that is broader than the universe of professional investors.

In addition, the Proposed Directive does not contain any transitional provisions addressing the effect of the Proposed Directive on existing AIFs and investors. Without the ability to market under national laws during the three year transitional period, it is not clear whether existing investors in an AIF would be permitted to purchase additional shares or units, for example.

D. The Professional Investor Limitation

Authorisation under the Proposed Directive will permit AIFMs to market shares or units in an AIF to professional investors in the European Community.[65] The term

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[64] Communiqué, Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 14 March 2009.

[65] Article 31, Article 33 and Article 39 of the Proposed Directive.

"professional investor" in the Proposed Directive was taken from Annex II of the MiFID Directive.[66] This definition sets out a list of entities which may be considered professional investors and includes an opt-in provision that would allow certain public sector entities and private individual investors to be treated as professional investors.

Under the opt-in provision, an individual (or public sector entity) would need to meet at least two of the three criteria below in order to qualify:

1. The client has carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters. This criterion would be difficult for many sophisticated, affluent and able individuals to satisfy, especially prospective individual investors in private equity funds or funds that invest in emerging markets. Many individuals will seek to invest in these types of AIFs because they would not otherwise have access to such investment opportunities.

2. The size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds €500,000.

3. The client works or has worked in the financial sector for at least one year in a professional position which requires knowledge of the transactions or services envisaged.[67]

Because marketing under the Proposed Directive is only permitted with respect to professional investors in a Member State, there will be certain types of investors, notably certain highly sophisticated, high net worth individuals, who can invest in AIFs under current private placement rules but who will be unable to purchase shares of an AIF whose manager is authorised under the Proposed Directive as they will not qualify as professional investors. Without suggesting in any way that investments in AIFs should be available to unsophisticated or retail investors, we would urge the EU not to adopt restrictions on the persons to whom AIFs may be marketed in the EU that arbitrarily exclude sophisticated high net worth individuals or other sophisticated investors in the manner that the proposed definition of professional investor would. Even if the prospect of extending the range of permitted investors beyond professional investors to include high net worth individuals is rejected, we would urge the EU to consider grandfathering provisions to address the status of AIF investors who were previously qualified to invest under applicable national laws but who will not qualify as professional investors.

IV. Effects on Existing Contractual Arrangements, AIFs and EU Investors

As noted above, the Proposed Directive does not include any transitional arrangements detailing how the Proposed Directive should apply to existing contractual arrangements, existing AIFs or existing EU-based investors. Because the Proposed Directive

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[66] Article 3(f) of the Proposed Directive.

[67] See Annex II of the MiFID Directive.

does not contain any grandfathering provisions, a plain reading of the Proposed Directive suggests that no later than the date set for compliance with the terms of the Proposed Directive:

1. An EU AIF with a non-EU AIFM will need to either: (i) seek a voluntary liquidation; (ii) reincorporate in a non-EU jurisdiction; or (iii) engage an EU AIFM, since the Proposed Directive prohibits a non-EU AIFM from providing management services to an EU AIF.

   A voluntary liquidation (i) would require the sale of portfolio investments which could further depress prices of many securities; (ii) could have adverse tax consequences for investors; and (iii) in the case of AIFs with illiquid portfolios, may take a significant period of time to accomplish.

   Reincorporation of an AIF would cause the AIFM and the AIF to incur substantial costs, including potential tax implications, which would likely be passed along to investors.

   Depending on the form of organisation of the AIF and the contractual arrangements, it may not be possible for an AIF to appoint an alternative or suitable alternative AIFM.

2. EU AIFMs will need to discontinue any delegations of portfolio and risk management functions to any non-EU AIFMs and perhaps make replacement internal arrangements or enter into delegation arrangements with other EU AIFMs. Suitably qualified people may not be available in the EU, leading to risks to investors or the unnecessary liquidation of an existing investment vehicle.

3. A non-EU AIFM would need to determine whether it should discontinue any delegation of management services to an EU AIFM. If delegation is to continue, any affected non-EU AIF would need to comply with the various substantive terms of the Proposed Directive that would apply by virtue of employing an EU AIFM. If the delegations are discontinued, alternative portfolio management arrangements may need to be made.

4. EU AIFMs will need to consider whether the service providers to their AIFs (administrators, valuators, depositaries) meet the requirements of the Proposed Directive and, if they do not, contractual arrangements with existing service providers may need to be terminated and contracts negotiated with others.

Where a non-EU AIFM manages a non-EU AIF that historically has been offered to EU-based investors, it is not clear what the consequences for such entities and investors would be. Because the definition of "marketing" under the Proposed Directive is "any general offering or placement of units or shares in an AIF to or with investors domiciled in the [European] Community, *regardless of at whose initiative the offer or placement takes place*"[68] (emphasis

[68] Article 3(e) of the Proposed Directive. This provision would eliminate the reverse enquiry process that is currently allowed in some Member States that do not currently allow marketing of AIFs by AIFMs.

added), the Proposed Directive may prohibit current investors in an non-EU AIF from purchasing additional shares or units of that non-EU AIF if previously applicable national laws are no longer available. The Proposed Directive does not clearly address whether non-EU AIFMs would be able to continue to market AIFs to existing EU investors under any existing national laws. If the Proposed Directive does not preclude non-EU AIFMs from marketing AIFs in the EU, it would be left to each Member State to determine whether to permit or prohibit further investments by EU investors who invested under current national laws or to limit the types of information that may be provided to existing investors.

For easy reference, the table in the Appendix provides a high level summary of the effects of the Proposed Directive during the first three years following the adoption of the Proposed Directive and thereafter.

V. Other Matters

A. Confidential Treatment of Regulatory Reporting

There are various provisions in the Proposed Directive (*e.g.,* Articles 11, 19, 21, 24 and 46) that establish regulatory reporting requirements. There is a lack of discussion in the Proposed Directive regarding regulators protecting the confidentiality of proprietary information provided by AIFMs under the requirements of the Proposed Directive.

We understand the importance of market participants providing information to regulators that regulators may determine is necessary or advisable to help them assess, on both a current and a forward-looking basis, potential risks to the financial system. However, because much of this information will be sensitive, proprietary information about AIFs, it is critical that the information be kept confidential, both by regulators receiving the information, and any other regulatory body with which that the information is shared. We would urge the EU to address these confidentiality concerns in any final directive.

B. Acquisitions of Controlling Stakes

The Proposed Directive contains disclosure requirements that apply when an AIFM managing one or more AIFs which either individually or in the aggregate acquires (or enters into an arrangement to acquire) 30% or more of the voting rights of a listed or unlisted company in the EU. The Proposed Directive would not require an AIFM to disclose acquisitions in relation to companies that are below certain *de minimis* requirements. The Proposed Directive would require disclosure to the issuer, the issuer's shareholders and representative employees of, *inter alia*, the development plan, the policy for preventing and managing conflicts of interest and the policy for external and internal communication of the issuer, in particular as regards employees.

As is the case with other aspects of the Proposed Directive discussed above, we believe that the Proposed Directive should not single out activities of AIFMs and AIFs for regulation where other types of market participants are not subject to the same blanket requirements, as such restrictions would have an anti-competitive impact on AIFMs and AIFs.

VI. Conclusion

AIFs play a significant role in the economy by helping pension plans, insurance companies and other institutional investors as they seek to achieve their financial goals, providing liquidity, reducing the volatility of market cycles, and providing access to capital for businesses of all sizes and types, especially where credit is limited from other sources.

The issues raised in this White Paper are of significant importance to MFA and its members inside and outside the EU. We appreciate the efforts of the European Commission in developing a thoughtful framework for the regulation of AIFMs. We look forward to working with EU officials and representatives as they work further to refine this framework.

APPENDIX

	EU AIFM Within 3 Years of Effectiveness	EU AIFM More Than 3 Years After Effectiveness	Non-EU AIFM Within 3 Years of Effectiveness	Non-EU AIFM More Than 3 Years After Effectiveness
Permitted to manage an EU AIF?	Yes, if authorised under the Proposed Directive	Yes, if authorised under the Proposed Directive	No	No
Permitted to manage a non-EU AIF?	Yes, if authorised under the Proposed Directive and the non-EU AIF conforms to the requirements regarding delegations, depositaries, valuators, etc.	Yes, if authorised under the Proposed Directive and the non-EU AIF conforms to the requirements regarding delegations, depositaries, valuators, etc.	Yes. Not affected by the Proposed Directive	Yes. Not affected by the Proposed Directive
Permitted to delegate management duties to an EU AIFM?	Yes, if the delegate is authorised or exempt under the Proposed Directive	Yes, if the delegate is authorised or exempt under the Proposed Directive	Yes, but if the EU AIFM is not exempt, the relevant AIF will be required to conform to the requirements regarding delegations, depositaries, valuators, etc.	Yes, but if the EU AIFM is not exempt, the relevant AIF will be required to conform to the requirements regarding delegations, depositaries, valuators, etc.
Permitted to delegate management duties to a non-EU AIFM?	No	No	Yes. Not affected by the Proposed Directive	Yes. Not affected by the Proposed Directive
Permitted to market an EU AIF in the EU?	Yes. An AIFM authorised under the Proposed Directive may market under passport if the AIF conforms to the requirements regarding delegations, depositaries, valuators, etc. Marketing under existing national laws may also be permitted.	Yes. An AIFM authorised under the Proposed Directive may market under passport if the AIF conforms to the requirements regarding delegations, depositaries, valuators, etc. Marketing under existing national laws may also be permitted.	Not permitted to seek authorisation under the Proposed Directive to market in the EU during this period. Marketing under any existing national laws might be permitted, but this is unclear.	Yes, if authorised under the Proposed Directive but each AIF will need to be subject to requirements deemed equivalent to the requirements under the Proposed Directive regarding delegations, depositaries, valuators, etc. Marketing under any existing national laws might be permitted, but this is unclear.

	EU AIFM Within 3 Years of Effectiveness	EU AIFM More Than 3 Years After Effectiveness	Non-EU AIFM Within 3 Years of Effectiveness	Non-EU AIFM More Than 3 Years After Effectiveness
Permitted to market an EU AIF outside the EU?	Yes subject to applicable private placement rules. Marketing outside the EU is not governed by the Proposed Directive	Yes subject to applicable private placement rules. Marketing outside the EU is not governed by the Proposed Directive	Yes subject to applicable private placement rules. Marketing outside the EU is not governed by the Proposed Directive	Yes subject to applicable private placement rules. Marketing outside the EU is not governed by the Proposed Directive
Permitted to market a non-EU AIF in the EU?	Yes, but subject to limitations. An AIFM authorised under the Proposed Directive may market any non-EU AIF it manages in its home Member State immediately upon authorisation if the non-EU AIF was organised in a qualifying jurisdiction and conforms to the requirements regarding delegations, depositaries, valuators, etc. An AIFM authorised under the Proposed Directive is not permitted to market non-EU AIFM in other Member States under a passport during this period but marketing in other Member States under existing national laws may be permitted.	Yes. An AIFM authorised under the Proposed Directive may market under passport if the AIF was organised in a qualifying jurisdiction and conforms to the requirements regarding delegations, depositaries, valuators, etc. Marketing under existing national laws may also be permitted.	Not permitted to seek authorisation under the Proposed Directive to market in the EU during this period. Marketing under any existing national laws might be permitted, but this is unclear.	Yes, if authorised under the Proposed Directive but each AIF will need to be subject to requirements deemed equivalent to the requirements under the Proposed Directive regarding delegations, depositaries, valuators, etc. Marketing under any existing national laws might be permitted, but this is unclear.
Permitted to market a non-EU AIF outside the EU?	Yes subject to applicable private placement rules. Marketing outside the EU is not governed by the Proposed Directive	Yes subject to applicable private placement rules. Marketing outside the EU is not governed by the Proposed Directive	Yes subject to applicable private placement rules. Marketing outside the EU is not governed by the Proposed Directive	Yes subject to applicable private placement rules. Marketing outside the EU is not governed by the Proposed Directive