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FINANCIAL MARKETS LAW COMMITTEE

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Analysis of certain core areas of the Alternative Investment Fund Managers Directive which are capable of giving rise to significant legal uncertainty

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FINANCIAL MARKETS LAW COMMITTEE

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1. INTRODUCTION AND EXECUTIVE SUMMARY

A. Introduction

1.1 The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2 In April 2009, the European Commission published a proposal for a Directive on Alternative Investment Fund Managers (the "Commission's Proposal")[2] with a view to addressing a wide range of risks which, it believes, present a threat to creditors, trading counterparties and to the stability and integrity of the European financial markets.

1.3 Owing to the cross-border dimension of these risks, the European Commission is of the opinion that nationally fragmented approaches do not constitute a sufficiently robust and comprehensive response and that a comprehensive legislative instrument in the form of its proposal is therefore necessary.

1.4 The Presidency of the Council of the European Union published a "Revised Presidency compromise proposal" on 25 November 2009 (the "Presidency Compromise Text")[3] and on 15 December 2009 (the "Final Swedish Presidency Text"[4] and together with the Presidency Compromise Text, the "Presidency Compromise Texts"), each of which suggests various amendments to the Commission's Proposal.[5] Where appropriate, this paper considers those amendments to the Commission's Proposal which were proposed by the Presidency Compromise Texts.

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2 2009/0064 (COD)

3 16622/09

4 17330/09

5 On each of 12 October, 23 October, 4 November and 12 November 2009, the Presidency of the Council of the European Union published compromise proposals suggesting amendments to the Commission's Proposal (the "Pre-existing Presidency Compromise Proposals"). To the extent that the Presidency Compromise Text does not consolidate all of the proposals set out in the Pre-existing Presidency Compromise Proposals, this paper does not consider the text of the latter.

1.5 The purpose of this paper is to highlight a number of provisions in the Commission's Proposal and the Presidency Compromise Texts which are capable of giving rise to significant legal uncertainty unless clarified. As the Directive on Alternative Investment Fund Managers (the "Directive") may, once finalised, be based wholly or in part upon the Commission's Proposal, this paper analyses key aspects of the Commission's Proposal whilst giving due consideration to the provisions of the Presidency Compromise Texts, where applicable.

B. Executive Summary

1.6 This paper does not seek to address all ambiguities and uncertainties generated by the Commission's Proposal or the Presidency Compromise Texts; nor does it seek to identify exhaustively all potential concerns with respect to the issues raised. In the FMLC's discussions with representatives of the fund management industry and with other participants in the wholesale financial markets, it became clear that a virtually limitless number of legal uncertainty issues could be raised with regards to the Commission's Proposal and the Presidency Compromise Texts. A number of those issues do not form part of this paper. The purpose of this paper is to highlight certain fundamental issues which would, in the FMLC's view, create significant legal uncertainty leading potentially to systemic failure and widespread market disruption, unless they are appropriately amended.

1.7 The FMLC's main areas of concern are summarised below. Of these, issues (a) to (e) remain acute, notwithstanding the publication of the Presidency Compromise Texts and each of these issues is considered below under "(A) Outstanding issues yet to be adequately addressed by the Presidency Compromise Texts". Issues (f) to (k) have, on the other hand, been tackled in the Presidency Compromise Texts in a way which is, at least, partly reassuring and each of these issues is addressed below under "(B) Issues substantially addressed by the Presidency Compromise Texts".

(a) The scope of the Commission's Proposal; in particular, uncertainty as to the meaning of the central concepts, "Alternative Investment Fund" (or "AIF") and "Alternative Investment Fund Manager" (or "AIFM"); and

uncertainty as to the activities which should constitute regulated activities for the purposes of the Directive.

(b) The liability regime for depositaries including, *inter alia*, the imposition of a very high standard of care on depositaries, and consequent low liability threshold, in respect of their own failures and those of any sub-custodians that they appoint, which may result in the insolvency of sub-custodians having systemic "knock-on" implications for the wholesale financial market.

(c) The depositary's obligation to verify whether the AIF or the AIFM, on behalf of the AIF, has obtained the ownership of all other assets in which the AIF invests; in particular, the difficulty in interpreting this obligation and the practical problems associated with fulfilling the obligation.

(d) The delegation restriction on depositaries and the potential inadvertent effects of such restriction.

(e) The inconsistencies and inherent conflicts between the Commission's Proposal and existing financial services directives which create legal uncertainty as to the general application of Community legislation.

(f) The delegation restriction on AIFMs, which is uncertain in many respects and at odds with the structures of many funds.

(g) The difficulty that would be experienced by some established funds in adapting to the requirements set out in the Commission's Proposal in the absence of any "grandfathering" provisions.

(h) The definition of "leverage", which requires further clarification, and the provision for the European Commission to set limits on the amount of leverage which AIFMs can employ.

(i) The protection afforded by the Presidency Compromise Texts to national private placement regimes (which allow AIFMs to market AIFs established in third countries to professional investors on their territory subject to national law); and the potential for confusion and uncertainty

that may arise as a result of the current positioning of such provisions in the Presidency Compromise Texts.

(j) The International Standards Requirement (as defined in paragraph 9 below) in the Presidency Compromise Texts which is applicable to authorised AIFMs when managing non-EU funds and the uncertainties surrounding its application.

(k) The Equivalence Requirement (as defined in paragraph 10 below), particularly as it is set out in the Commission's Proposal, that forms the legal context for restrictions on marketing by non-EU funds, which it may be extremely difficult, if not impossible, to satisfy in practice.

(A) OUTSTANDING ISSUES, YET TO BE ADEQUATELY ADDRESSED BY THE PRESIDENCY COMPROMISE TEXTS

2. THE SCOPE OF THE COMMISSION'S PROPOSAL

2.1 "Collective Investment Undertaking"

2.1.1 The Commission's Proposal applies to all AIFMs established in the Community which provide management services to one or more AIFs.[6] This latter concept, the AIF, is not clearly delimited by the Commission's Proposal despite the fact that it is a key concept around which the regulatory ambit of the Directive is established and even though there are significant consequences for fund managers which fall within that ambit. The Commission's Proposal defines an AIF as:

> any *collective investment undertaking*, including investment compartments thereof whose object is the collective investment in assets and which does not require authorisation pursuant to Article 5 of Directive 2009/…/EC [the UCITS Directive] (complete with internal citation, emphasis added).[7]

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6 Article 2 of the Commission's Proposal

7 Article 3(a) of the Commission's Proposal

2.1.2 The term "collective investment undertaking" is itself not defined in the Commission's Proposal and, although it is not new to European law, it has no pre-existing settled meaning. The term appears in the plural ("collective investment undertakings") in Article 3 of Council Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (the "UCITS Directive") and has become familiar to the markets in that context but it is a concept which is neither explained nor defined therein. Instead, the scope of the UCITS Directive is further circumscribed by additional provisions which clarify, *inter alia*, that it applies to collective investment undertakings which are "open-ended".[8] In contrast, it is clear by virtue of Article 2(1)(c) that the regulatory ambit of the Commission's Proposal is not restricted in the same way.[9]

2.1.3 Furthermore, the UCITS Directive as a whole refers (and applies) not simply to collective investment undertakings but specifically to "undertakings for collective investment in transferable securities" ("UCITS"). It provides that a UCITS is an undertaking with the sole object of collective investment in transferable securities or in other liquid financial assets, which raises capital from the public, operates on the principle of risk-spreading and redeems or repurchases units from unit-holders out of its own assets.[10]

2.1.4 Although, there is some suggestion in the recitals that the Commission's Proposal intended to draw on some of these aspects of the definition of a UCITS in the UCITS Directive, a literal interpretation of the AIF definition in the Commission's Proposal gives rise to the inference that the actual scope of the Directive is much more extensive. It applies, subject to Article 2(2), to AIFMs which manage collective investment undertakings regardless of the legal form of those undertakings, the object of their investment or the type of assets in which they invest (provided that such undertakings do not require authorisation under

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8 See Article 1(2) of the UCITS Directive

9 The fact that closed-ended funds fall within the scope of the Commission's Proposal means that there will be an overlap with funds, *inter alios*, which are issuers subject to the provisions of the Transparency Directive (as defined below). See Article 1(2) of the Transparency Directive.

10 Article 1(2) of the UCITS Directive

the UCITS Directive).[11] Any listed or unlisted company with a *commercial* purpose could, therefore, be categorised as a "collective investment undertaking" within the Commission's Proposal by virtue of its underlying shareholders and its profit-making objective. The breadth of this definition and, in theory, the scope of the Directive, is likely to give rise to very substantial uncertainty as commercial undertakings consider whether they are within the scope of a directive targeted at the investment management industry.

2.1.5 The FMLC believes that the Community's legislative intention is to regulate managers of collective investment undertakings which have at their core the object of investing for investment purposes rather than for purely commercial purposes. The very wide definition of AIFs, with its implications for the scope of the Commission's Proposal, is, therefore, at odds with this. To bring the scope of the Directive back into line with the Community's legislative intention, the FMLC suggests that an AIF is defined as:

> any collective investment undertaking, including investment compartments thereof whose object is collective investment, either: (i) *predominantly in financial assets or (ii) in a diversified portfolio of assets for investment rather than commercial purposes*, and which does not require authorisation pursuant to Article 5 of the UCITS Directive (emphasis added).

2.1.6 Even if the drafting of the Commission's Proposal is brought into line with what the FMLC believes to be its legislative intent in this way, certain exclusions from the AIF definition would arguably be required to remove any arrangements that ought not to be the subject of the substantive provisions of the Commission's Proposal. Examples of such potential exclusions should probably include employee or similar participation schemes and investment opportunities or arrangements established by special purpose entities. These exclusions

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11 In fact, the sole limitation that can be identified in this definition is implicit in the term "undertaking" which, although itself uncertain, in many ways, does appear to restrict the definition to "entities" rather than mere "arrangements". Thus, the FMLC is of the view that a specific exclusion would not be required for structured finance platforms established for the purposes of issuing securities under a medium term note or structured product programme as such mechanisms for collective investment constitute "arrangements" as opposed to "undertakings" for the purposes of the Directive.

appear self-evidently necessary, because it seems inconceivable that the provisions in the Commission's Proposal on, for example, depositaries and capital requirements, can be intended to apply to such arrangements.

2.1.7 The FMLC has also considered the AIF definition in the Presidency Compromise Texts. Whilst this definition appears, in some respects, wider than the definition in the Commission's Proposal (for example, the reference in the recitals to some of the limiting factors in the UCITS Directive's definition of a UCITS have been removed), an attempt has been made to address the need both for clarity and for the exclusions mentioned above. The Presidency Compromise Texts clarify that an AIF is a collective investment undertaking which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors. Article 2a of the Presidency Compromise Texts also expressly exempts employee participation schemes (the "Schemes"), certain special purpose entities ("SPEs") and certain group structures from the scope of the Directive.[12] Notwithstanding the fact that the Commission's Proposal and the Presidency Compromise Texts are directed solely at AIFMs, the Presidency Compromise Texts identify the Schemes and SPEs, which are more akin to AIFs, as exemptions from the general application of the Directive as if such arrangements themselves are the object of its regulatory thrust. The FMLC is of the view that these exclusions would be better placed in Article 3(1) of the Directive as carve-outs from the definition of an AIF. The indeterminate concept "a number of investors" as used in the definition of an AIF would also benefit from clarification.[13]

2.2 Management and Administration Functions of the AIFM

2.2.1 Although the Commission's Proposal applies to funds of every kind and strategy, it does not cater for the fact that there are many possibilities for the structuring

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12 Articles 2a of the Presidency Compromise Texts

13 Greater certainty could perhaps be provided by specifying a minimum number of investors in the AIF. (A significant number of investors should be required before an undertaking is characterised as a collective investment undertaking.) However, in making any such clarification the danger of possible evasion must be properly considered. It is also important to clarify how the term, "collective investment undertaking", applies to master-feeder fund structures. It is arguable, for example, that a master fund which has only one or two feeder funds would fall outside the scope of the Directive because it is not raising capital from a "number of investors" and does not therefore qualify as a collective investment undertaking.

of the fund arrangements.[14] The Commission's Proposal is expressed to apply to any AIFM which provides an AIF with "management and administration" services, but it is not the case that in every fund these services are carried out by, or are the responsibility of, a single third-party service provider. The Commission's Proposal applies to external third-party AIFMs but fails to encompass the class of AIFs that undertake internally the management and administration functions without any involvement of an external third-party AIFM.

2.2.2 In practice, there are many common fund structures used throughout Europe where the fund vehicle has an internal management board which exercises the overall supervisory functions and which sets or approves the investment policy and appoints one or more managers and, in some cases, separate administrators. Further, closed-ended funds in the form of bodies corporate will often have both a board of directors with overall responsibility for the entity's affairs as well as an external manager responsible for execution of the entity's investment policy and possibly also its affairs more generally. However, in some cases, the board may not delegate investment management functions to a fund manager at all, but will itself take all investment decisions, perhaps upon receipt of non-binding advice from specialists. On the current construction of the Commission's Proposal, there is no clarity as to which entity would be classified as the AIFM in such cases or indeed whether more than one entity might be regarded as an AIFM of the same AIF.

2.2.3 These concerns have been considered in the Presidency Compromise Texts which:

(A) reflect the fact that, whilst some AIFs outsource their management functions, other AIFs manage themselves internally;

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14 Different structures with regard to hedge funds are described in the Principles for the Valuation of Hedge Fund Portfolios – Final Report, Report of the Technical Committee of IOSCO November 2007. In addition, the Commission's Impact Assessment (SEC(2009) 576) which was published in conjunction with the Commission's Proposal cites a study which was undertaken in nine EU Member States. The study identified more than sixty different legal vehicles which were being used for non-harmonised funds. Details of the study can be found in a report prepared by PricewaterhouseCoopers for the European Commission and DG Internal Market and Services in October 2008 which is entitled "The retailisation of non-harmonised investment funds in the European Union".

(B) amend the scope of the Commission's Proposal so that it applies to all AIFMs established in the Community which manage one or more AIFs irrespective of whether or not the AIFM undertakes administrative services in relation to such AIF(s); and

(C) clarify that each AIF managed within the scope of the Directive shall have a single AIFM.

The FMLC supports these proposals.

2.3 Administration – Regulated Activity or Unregulated Activity?

2.3.1 The position of fund administrators under the Commission's Proposal is particularly unclear. It is very common in some types of fund for management to be separated from administration. In the most basic version of this arrangement, the fund manager provides investment management or advice and other management or advisory services but various aspects of the administration of the fund are outsourced to a company specialising in fund administration. These services include: accounting, secretarial services, compliance provision, registrar services and, possibly, shareholder servicing.

2.3.2 Whilst it is clear from the Commission's Proposal that the provision or delegation of administration services is considered to be a function of the AIFM and is, therefore, a regulated activity, it is not clear whether the services listed in paragraph 2.3.1 above constitute "administration" services for the purposes of the Commission's Proposal and whether, going forward, it is the intention that the provision of such services generally by a fund administrator or another third-party service provider should constitute a regulated activity.

2.3.3 The FMLC understands that each of the Presidency Compromise Texts identifies what should constitute administration services for the purposes of the Directive and that each of the services listed in paragraph 2.3.1 above have been specified in some form. The FMLC is in favour of this clarification.[15] However, the clarification has not been supplemented by any provision drawing a further

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15 Annex I Paragraph 2 of the Presidency Compromise Texts

distinction between regulated and unregulated administrative activities. Distinguishing between those administrative functions which could be categorised as "primary" or executive functions and those which could be categorised as "secondary"[16] or functionally basic functions may be the first step to achieving transparency in this regard although this, in itself, may not be an easy feat. Valuation and pricing may, for example, be considered to be a primary function; although arguably, it is only the entity responsible for ensuring that the AIF is valued and priced properly that should be regulated and not the entity that merely performs the calculations. As it currently stands, the provision or delegation by the AIFM of any of the identified administration services does appear to constitute a regulated activity under the Presidency Compromise Texts, including those services listed above which can be regarded as "secondary" or functionally basic.[17]

2.3.4 Further clarification is required to determine whether or not this reflects the legislative intent given that certain of the listed services typically carried out by an AIFM (such as secretarial services) can be classified as "secondary" services and would not normally be expected to be a matter of concern to regulators. The FMLC has been given to understand that the intention to exclude such services from the ambit of the Directive was implicit in the Commission's Proposal and that the term "administration services" was intended to apply only to certain high-level executive functions, such as fund valuation. The Committee would welcome clarity on this point. If, on the other hand, the intention is indeed to include "secondary" administration services within the regulatory ambit of the Directive, the outsourcing of these services will presumably amount to a delegation by the AIFM under Article 18, which seems unnecessarily restrictive given the stringent limitations in Article 18 and the very mundane character of some administrative responsibilities.

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16 Dealing with customer enquiries and maintaining the unit-holder/shareholder register are examples of administrative functions which could potentially be categorised as "secondary" functions.

17 Recital 14 and Article 18 of the Presidency Compromise Texts relate (expressly or implicitly) to all functions of the AIFM and, therefore, it is understood that all functions, even the most mundane administrative ones, are regulated functions of the AIFM.

2.4 Valuation

Among the services that may be outsourced by the AIFM, fund valuation deserves special consideration. The Commission's Proposal requires the AIFM to ensure that an independent valuator is appointed for each AIF that it manages.[18] The Presidency Compromise Texts, taking account of current market practice, progress the drafting further by acknowledging that fund valuation may be undertaken by the AIFM itself or, alternatively, may be outsourced to an external valuer. The FMLC welcomes the amendments proposed by the Presidency Compromise Texts.[19] However, regard must also be had to the fact that there may be circumstances, particularly when the AIF holds liquid assets, where the valuation is undertaken by the internal management of the AIF rather than by an externally appointed AIFM or a third-party valuer. Neither the Commission's Proposal nor the Presidency Compromise Texts currently contemplate this structure.[20]

2.5 Private Equity Funds

2.5.1 It is not for the FMLC to comment on the fairness, or otherwise, of the regulatory requirements imposed on AIFMs. However, some of the provisions in the Commission's Proposal are difficult to interpret in light of their application to AIFMs of private equity funds; particularly since the Explanatory Memorandum in the Commission's Proposal acknowledges that private equity funds do not contribute to macro-prudential risks. The provisions in question require AIFMs, *inter alia*, to:

(A) ensure that a depositary is appointed to each private equity fund which it manages,[21] despite the fact that this may be wholly unnecessary given the

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18 Article 16(1) of the Commission's Proposal

19 Article 16(2) of the Presidency Compromise Texts

20 Article 17(1a)(b) of the Presidency Compromise Texts obliges the depositary to ensure that the value of the shares or units of the AIF are calculated in accordance with the applicable national law and the AIF rules or instruments of incorporation. However, it is not clear how this valuation obligation relates to the main valuation provisions in Article 16 of the Presidency Compromise Texts and whether the valuer is thus impliedly required to take into account the AIF's national law and rules and instruments of incorporation in reaching a valuation figure. Further clarification would be welcomed in this regard.

21 Article 17(1) of the Commission's Proposal

nature of its investments.[22] The extent to which the private equity fund is then required to make active use of the appointed depositary to provide the redundant "protection" is unclear;

(B) comply with detailed disclosure obligations where the private equity fund acquires a substantial shareholding in an Issuer[23] or a non-listed company; and, if the shares of that Issuer are no longer admitted to trading on a regulated market, to continue to comply with the provisions of Directive 2004/109/EC on the harmonisation of transparency requirements with regard to information about issuers whose securities are admitted to trading on a regulated market (the "Transparency Directive") for two years from the date of delisting (the "Delisting Requirement");[24] and

(C) employ an appropriate liquidity management system and to adopt procedures that ensure that the liquidity profile of the private equity fund's investments complies with its underlying obligations. The latter appears to be a reference to their redemption policy.[25] If so, this obligation is arguably redundant in relation to a closed-ended private equity fund which, by its nature, is under no obligation to redeem shares at the request of investors. The FMLC understands that the Presidency Compromise Texts propose that this obligation does not extend to closed-ended funds that do not use leverage and the FMLC is in favour of this development.

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22 An independent custodian would not be required where the AIF's assets are share certificates in private companies; and, although private equity companies may use cash to fund an investment, this will typically be drawn down only when required and will be segregated from the manager's assets and paid into a bank account. The appointment of a depositary may also be wholly unnecessary for other types of AIF that invest in illiquid assets or liquid assets which are not exchange traded securities. In such circumstances, it is not particularly obvious why the Commission's Proposal and the Presidency Compromise Texts require a depositary to be appointed to each AIF rather than imposing an obligation on the AIFM to segregate the assets of each AIF it manages.

23 See footnote 87 below.

24 See detailed analysis in paragraph 4.4 (Information about major holdings) below

25 Article 12(1) of the Commission's Proposal

2.6 Threshold Exemption

2.6.1 The Commission's Proposal shall not apply to any:

> AIFM which either directly or indirectly through a company with which the AIFM is linked by common management or control, or by a substantive direct or indirect holding, manage portfolios of AIF whose assets under management, including any assets acquired through use of leverage, in total do not exceed a threshold of 100 million Euro or 500 million Euro when the portfolio of AIF consists of AIF that are not leveraged and have no redemption rights exercisable during a period of 5 years following the date of constitution of each AIF.[26]

2.6.2 The intended scope and application of Article 2(2)(a) of the Commission's Proposal (the "Threshold Exemption") is not wholly apparent. The concept of an AIFM "directly" managing the portfolios of one or more AIFs is fairly straightforward (although the question arises whether some arrangements which involve management intermediation other than through a company (for example, through a delegate AIFM) may fall within a penumbra of uncertainty here), but the concept of the AIFM "indirectly" managing a portfolio of an AIF through a company is arguably more obscure. It presumably only captures scenarios where the AIFM *delegates* its portfolio management function. However, it may conceivably be intended to capture other, less-linear relationships within which the AIFM might be taken to have retained a role in portfolio management or have such a role imputed to it by reason of its association with the management company. In either case, clarification is needed in Article 2(2)(a).

2.6.3 More specifically, there has been some debate as to whether or not it is the European Commission's intention in Article 2(2)(a) to aggregate all AIF portfolios, which are managed by related entities, in the same group as the AIFM for the purpose of applying the Threshold Exemption. The drafting here exacerbates the uncertainty. Instead of drawing on established concepts of

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26 Article 2(2)(a) of the Commission's Proposal

European law relating to group undertakings, the new and uncertain phrase "linked by common management or control" is used. The intention may be for this new formulation to have the same meaning as a group of undertakings but one cannot be sure (A) what size of holding is "substantive"; and (B) whether it is voting control, capital or income rights (or a combination of the above) which is determinative.

2.6.4 Even if these conceptual uncertainties were resolved, AIFMs could quite easily pass and re-pass over the threshold, thus falling in and out of the scope of the Directive, over a period of time as a result of volatility in the net asset value of the AIFs they manage. Such volatility would cause considerable confusion and uncertainty for the AIFMs themselves, the competent authorities of the individual Member States and the public at large. The confusion would be compounded by the fact that the Threshold Exemption also results in the bifurcation of the regulatory regime applicable to AIFMs. AIFMs which satisfy the Threshold Exemption will not be subject to the national measures which transpose the Directive into national law, whilst those that do not satisfy the Threshold Exemption will be subject to such measures. The Presidency Compromise Texts attempt to address this concern by providing that the European Commission shall adopt implementing measures clarifying how to treat an AIFM whose assets under management in one and the same calendar year occasionally exceed or fall below the relevant threshold.[27] The Threshold Exemption has an important role in determining whether or not an AIFM is subject to the national measures which transpose the Directive into national law and, for that reason, the FMLC would recommend that the necessary clarification is provided in the Directive itself and not subsequently in implementing measures.

2.6.5 In addition, the concept of "leverage" is critical for determining if an AIFM falls within the Threshold Exemption. However, this concept is not defined with any

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27 Article 2a(3) of the Presidency Compromise Texts

precision and its use, therefore, has the effect of causing confusion and weakening the effectiveness of the Threshold Exemption.[28]

2.6.6 There is also concern that AIFMs could use the Threshold Exemption as a means of avoiding the regulatory protections afforded by the Directive by setting up a series of exempt funds which invest in an off-shore master fund, none of which would fall within the scope of the Directive's application.

2.6.7 On the basis of the above, the FMLC recommends the removal of the Threshold Exemption from the Directive. The Committee acknowledges that this would constitute a fundamental change to the Commission's Proposal which may require, as part of the co-decision procedure, the European Parliament and the Council to undertake an impact assessment prior to the adoption of any such amendment.[29] Whilst such a suggestion may initially disrupt the legislative timetable, it would have the added advantage of giving greater opportunity for consideration of the Directive's scope and the clarity with which it is delimited. Alternatively, to ensure that the dangers set out in paragraph 2.6.4 are avoided, the FMLC suggests that the parameters of the Threshold Exemption are established with greater exactitude in the Directive.

3. DEPOSITARIES

3.1 Liability of Depositaries

3.1.1 Overview

3.1.1.1 Article 17 of the Commission's Proposal makes regulatory provision for depositaries appointed to provide custodial services to AIFs. Article 17(1) of the Commission's Proposal affirmatively requires the AIFM to ensure that a depositary is appointed for each AIF it manages and proceeds to identify key functions which the depositary is appointed to fulfil. Such functions are not precisely defined but include, *inter alia*, safe-keeping[30] any financial instruments

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28 For further analysis on "leverage", see paragraph 7 (Leverage) below.

29 Article 30 of the Interinstitutional Agreement on better law-making, (OJ C 321, 31.12.2003).

30 Safe-keeping the assets of an AIF is one of the key *raisons d'être* of the depositary. However, it is doubtful that harmonisation can be achieved across the Community without further clarification as to what this notion means for the purposes of the Directive as the nature of the "safe-keeping" function differs across individual Member States.

which belong to the AIF and 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. The depositary functions are expanded in greater detail in Article 17(1) of the Presidency Compromise Text. Article 17(2) of the Commission's Proposal imposes a non-contractual duty of care on the depositary which is owed to the investors in the AIF. The Presidency Compromise Text extends this non-contractual duty of care so that it is owed to the AIF or the investors in the AIF.[31] Interestingly, liability for breach of this duty is imposed on the depositary not only vis-à-vis the investors in the AIF and the AIF, but also vis-à-vis the AIFM itself by virtue of Article 17(5) of the Presidency Compromise Text which provides that:

> the depositary shall be liable to the AIFM and the investors of the AIF for any losses suffered by them as a result of its failure to perform its obligations pursuant to paragraphs 1, 1a, 2a, 4 and 4a.[32]

Whilst delegation of the depositary functions is permitted, the Commission's Proposal provides that the liability of the depositary shall not be affected by any act of delegation.[33]

3.1.1.2 The provisions of the Commission's Proposal and of the Presidency Compromise Texts which relate to the liability of depositaries give rise to a number of issues of legal uncertainty. In brief, it is unclear:

(A) how a depositary will ever be able to meet the new high standard of care applicable to it in the context of a loss of financial instruments or the standard "to act fairly" imposed upon it under Article 17(2a) of the Presidency Compromise Text;

(B) whether or not the Commission's Proposal and the Presidency Compromise Texts are attempting to create a new liability regime for losses without limitation;

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31 Article 17(2a) of the Presidency Compromise Texts

32 Article 17(5) of the Commission's Proposal

33 Article 17(4) and Article 17(5) of the Commission's Proposal

(C) how the liabilities owed by the depositary to the AIF, the AIFM and the investors of the AIF interrelate; and

(D) how the defence in Article 17(7) of the Presidency Compromise Texts could ever be relied upon by depositaries in light of the obscure concepts used therein.

In the analysis that follows of (B) above, it was thought helpful to consider the Commission's Proposal and the Presidency Compromise Texts (where relevant) against three comparators from the Community's financial services legislation, namely the UCITS Directive, Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading (the "Prospectus Directive") and the Transparency Directive.

3.1.1.3 On a separate note, whilst it is not for the FMLC to comment on issues of policy, in addition to the above, there is concern that the imposition of a form of vicarious liability on depositaries for the activities of their sub-custodians could increase the likelihood of a systemic failure and therefore, due to the potential impact which such provision may have on the wholesale financial markets, it needs to be considered whether some kind of prior impact assessment is required in this regard.

Each of the above issues is considered in turn below.

3.1.2 <u>The Standard of Care</u>

3.1.2.1 In the event of any loss of financial instruments which the depositary safe-keeps, the Commission's Proposal provides that the depositary can only discharge itself of liability *if it can prove* that it could not have avoided the loss which occurred (the "New Standard of Care").[34] In other words, the burden of proof which requires the claimant to establish all elements of its claim including breach of any duty of care by the defendant is reversed and the standard of care is raised beyond the care that would be exercised by the

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34 Article 17(5) of the Commission's Proposal

reasonable custodian, to the standard that would be exercised by a custodian who takes every logical and possible step to avoid loss to the investors, regardless of difficulty or expense. The New Standard of Care is a cause of great concern as the Commission's Proposal does not set out criteria for compliance therewith and, under Member States' law, there may be no established authority on what the phrase "could not have avoided the loss" means. It is, therefore, likely that this New Standard of Care would be heavily litigated in the Member States' courts. This is problematic on two levels. First, legal uncertainty continues whilst these issues are being resolved and secondly, these issues may be resolved differently in different Member States which would lead to a divergence in regulatory standards across the Community.

3.1.2.2 It is also unclear whether or not the depositary is permitted to contract out of the New Standard of Care in its agreement with the AIF. If it is so permitted, on the basis that there is no express prohibition to that effect, the depositary appears to remain vulnerable to claims for compensation in full from the AIFM and the investors in the AIF. As below, whilst there may be an intention implicit in the article as a whole that the depositary can modify its duties to the AIFM and the investors in the AIF by contract, it is entirely unclear how this might actually be achieved as such entities may not be principal parties to the contractual arrangement entered into with the depositary.

3.1.2.3 The FMLC is aware that the Presidency Compromise Texts propose the removal of the New Standard of Care and the FMLC welcomes this proposal. In the case of a loss of financial instruments held by a sub-custodian, the Presidency Compromise Texts propose that the depositary shall either return financial instruments of the same/identical type or the corresponding amount to the AIF or its investors without undue delay.[35] The Presidency Compromise Texts do, however, raise additional points of concern. Clarification is required as to when the extent of the depositary's liability should be determined. The process of identifying a loss of assets, quantifying it and pursuing claims against the depositary can be quite time consuming. This can be aggravated

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35 Article 17(4b) of the Presidency Compromise Texts

further in the event of an insolvency of the depositary, which has become apparent following Lehman's collapse. As the requirement on the depositary is to return assets of the same sort, then the potential cost of doing so will be fluctuating until the time when there is sufficient certainty for the depositary to make good the loss. It is a question of policy as to whether the depositary's liability should be capped at the time of the loss, the time of the discovery of the loss or the actual date of restitution although the position, once determined, should be expressly provided for in the Directive.

3.1.2.4 The Presidency Compromise Texts also provide that the depositary may, "on a contractual basis", discharge itself of its liability to return financial instruments of the same type or the corresponding amount to the AIF or the investors of the AIF, if it can prove that it has fulfilled its obligations under Article 17(4) and (4a). To understand fully the scope of this express carve-out from liability, further clarification as to what "on a contractual basis" means is required, especially given that the civil liability contemplated by the Commission's Proposal and the Presidency Compromise Texts arises from duties owed to parties (e.g. AIF investors and the AIFM) who may not be principal parties to any contract for custody services. Further uncertainty is introduced by the Final Swedish Presidency Text which provides that a depositary may, in the case of financial instruments held by a sub-custodian, discharge itself of liability for their loss, on a contractual basis, if, in addition to showing that it has complied with its obligations in connection with delegation, it can demonstrate that there is an "objective reason for such discharge".[36] Avoiding the exposure associated with the liability is a justification for contracting out of the liability and this would apply to a depositary in all cases. Therefore, *prima facie*, this additional requirement would appear to be wholly superfluous. It is not clear what, on the other hand, is meant by the term "objective reason" which appears to cover any fact-based, independently verifiable reason of the sort just referred to. If, by "objective" it is intended to signify reasons which are not relative to the depositary's own financial position then this should be made explicit. If this is indeed the intention, then

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36 Article 17(4b) of the Final Swedish Presidency Text

a contractual discharge will be available only in a very limited set of circumstances.

3.1.2.5 In all other cases where losses are suffered by the AIFM, the AIF or the investors in the AIF as a result of the depositary's failure to perform its obligations under the specific paragraphs identified in Article 17(5) of the Presidency Compromise Texts, the liability imposed on the depositary can be characterised as strict liability. Strict liability renders the depositary liable for the damage and loss caused by its acts and omissions regardless of culpability. This imposes a higher standard of care on depositaries than that specified in the UCITS Directive.[37] The FMLC is aware that the European Commission is consulting with the industry on whether it is appropriate to revisit the standard of care in the UCITS Directive to bring it in line with the Commission's Proposal. The FMLC is generally opposed to this proposal. The UCITS standard of care is based on many years of market experience and has the advantage of being the subject of a settled market understanding according to which it is applied and interpreted.[38] A more appropriate approach would be to incorporate the existing UCITS standard of care into the Directive.

3.1.3 Duty to Act Fairly

The Presidency Compromise Text provides that "in the context of their respective roles, the AIFM and the depositary shall act …fairly…".[39] Fairness is an obscure concept and further clarification and guidance is required for AIFMs and depositaries to be certain that the standard of conduct which they employ will satisfy their obligation to act fairly.[40] If further clarification is not provided, it is likely that, as highlighted above in the context of the New Standard of Care, the duty to act fairly will be heavily litigated in the Member

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37 Articles 24 and 34 of the UCITS Directive provide for the depositary to be liable to the management company or the investment company (as applicable) and the unit-holders for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance of them.

38 Recent events have highlighted the need for investor protection to be assured through proper enforcement of the existing obligations and liability of a depositary, but have not demonstrated inherent problems with the UCITS regime. The FMLC also notes that the CESR has made known to the Commission its opposition to the proposed changes to the standard of liability of depositaries in the UCITS Directive.

39 Article 17(2a) of the Presidency Compromise Texts

40 The duty to act fairly is not new to Community legislation. The concept of "fairness" arises in the UCITS Directive where management companies are obliged to act fairly in conducting their business activities and are also obliged to ensure that the UCITS they manage are fairly treated. The UCITS Directive does not, however, provide any greater insight into what the concept of "fairness" means.

States' courts which may result in a divergence in regulatory standards across the Community.

3.1.4 The Depositary's Duties

3.1.4.1 In practice, the contract for the provision of custody services is, most usually, entered into between the AIF and the depositary and, as a result, the depositary's contractual duty of care is owed exclusively to the AIF.[41] With respect to non-contractual duties of care, Member States' civil liability regimes impose such duties of care on depositaries primarily in respect of the AIF itself.[42] Loss suffered by individual investors will often be regarded as being merely "derivative" of the loss suffered by the AIF itself. The Commission's Proposal and the Presidency Compromise Texts, however, fail to reflect either the market practice contemplated in the parties' standard contractual arrangements or the tendency of many national civil liability regimes to exclude or discourage claims by individual investors for losses which are merely "derivative" of those suffered by the AIF.

3.1.4.2 The depositary shall, under the Commission's Proposal and each of the Presidency Compromise Texts, be liable to the AIFM and the investors of the AIF for any losses suffered by them as a result of its failure to perform its obligations.[43] By extending the depositary's liability to losses suffered by the AIF, the Presidency Compromise Texts prove themselves to be cognisant of the standard contractual arrangements which establish the custody relationship. However, the rationale for imposing liability on the depositary for losses suffered by the AIFM and the investors of the AIF is not entirely clear.

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41 In exceptional circumstances, the AIFM or the investors in the AIF as a collective body (i.e. in purely contractual AIFs where the AIF has no separate legal identity to its investors) may also be a party to the services contract.

42 The class of entities to whom a depositary owes non-contractual duties of care is not established under English law. It is arguable that the depositary may, as a result of a failure to perform its obligations, be liable to investors in an AIF in circumstances where damages payable to the AIF do not take account of specific losses incurred by individual investors in the AIF as a direct consequence of the depositary's breach of duty or, in purely contractual AIFs where the AIF has no separate legal identity, to its collective group of investors. However, it is difficult to see how the depositary's non-contractual duty of care could extend to the AIFM given the lack of proximity between the AIFM and the depositary (i.e. the AIFM would not normally be within the depositary's contemplation of those persons who would be so closely and directly affected by its acts). The FMLC considers it, therefore, unlikely that the depositary's non-contractual duty of care would naturally extend to the AIFM under English law.

43 Article 17(5) of both the Commission's Proposal and the Presidency Compromise Texts

3.1.4.3 First, with regard to the AIFMs, it is difficult to identify any nexus between a breach of duty by the depositary and a loss being suffered by the AIFM. Clarification is required to understand the types of AIFM-specific losses which the provision may be intended to capture. Arguably, the loss to the AIFM could be a loss of some form of performance fee which is linked to the adequate performance of custodial services. This would, however, constitute a very remote form of consequential loss. Alternatively, the reference to the "AIFM" in Article 17(5) of the Commission's Proposal may be an attempt to recognise, at the European level, departures from market practice where: (A) the contractual arrangement is between the depositary and the AIFM (on behalf of the AIF); (B) there is no direct legal relationship between the depositary and the AIF itself; (C) the AIF is a contractual AIF with no separate legal personality from its investors; and (D) the depositary's liability to the investors in the AIF is to be invoked indirectly through the AIFM as contemplated in Article 17(5) of the Commission's Proposal. If this is the legislative intention, an explicit statement to this effect is needed in the Directive and care must also be taken to ensure that the Directive does not inadvertently impose additional liability on the depositary vis-à-vis the AIFM as a separate legal entity distinct from the investors in the AIF.

3.1.4.4 In either case, further clarification is required to understand what is intended by the statement, "liability to AIF investors may be invoked either directly or indirectly through the AIFM".[44] As set out above, market practice dictates that, ordinarily, depositaries are appointed directly by the AIFs. Article 17(5) of the Commission's Proposal implies that there are potentially more complicated legal relationships which may be in place between the AIFM, the depositary and the investors in the AIF but the Commission's Proposal is silent on the characterisation of those relationships and fails to make clear how they may affect the depositary's liability to the AIFM and investors in the AIF.[45] The FMLC is of the view that there are at least two plausible interpretations.

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44 Article 17(5) of the Commission's Proposal and Article 17(6) of the Presidency Compromise Texts.

45 Article 24 of the UCITS Directive contains a similarly opaque provision allowing liability to unit-holders to be invoked either directly or indirectly through the management company, depending on the legal nature of the relationship between the depositary, the management company and the unit-holders.

The intention may be to create concurrent duties in contract and negligence, such that the depositary owes a duty in contract to the AIF and a non-contractual duty to its investors. This would be at odds with the parties' probable expectation that in structuring their relationship by way of contract, they will be taken to have excluded the non-contractual remedy. It also fails to address what is meant by the reference to "indirectly through the AIFM" as the AIFM would have no necessary role in such an arrangement. Alternatively, it may be the intention to create a form of statutory duty which allows the investors to compel the AIFM to bring some claim against the depositary but neither the Commission's Proposal nor the Presidency Compromise Texts establish a framework for the operation of such a right or describe how it might be asserted.

3.1.4.5 Secondly, with regard to the AIF investors, the intention may be for liability to be imposed on the depositary for losses suffered by the "investors in the AIF" in a limited set of circumstances where, for example, the AIF has no separate legal personality from its investors (i.e. in the case of a purely contractual AIF) or where the losses suffered by the AIF investors could be characterised as "personal" (i.e. losses which are not derived from the losses suffered by the AIF). Facilitating claims of the AIF investors (on behalf of the AIF), in circumstances where the AIFM or AIF itself is unwilling to bring such claims, may be another reason why the Commission's Proposal and the Presidency Compromise Texts extend the depositary's liability in this way. However, if the intention is for liability to be imposed on the depositary for losses suffered by AIF investors in a wider set of circumstances, Article 17(5) of the Commission's Proposal could be interpreted as imposing a duty on the depositary which is owed to each of the investors as individuals rather than as an unincorporated group. Any such interpretation of Article 17(5) would be of grave concern for depositaries as neither the Commission's Proposal nor the Presidency Compromise Texts dictate how the duties owed to different persons would interrelate or in whose interests the depositary should act in circumstances where the interests of the various investors in the AIF diverge or where the interests of the AIFM and those of the various investors in the AIF diverge. Given the complex structures and business operations of many

professional investors and the complex capital structures of many AIFs, it is very likely that the interests of an AIF's investors could, at any point in time, be wide-ranging and conflicting. This would have the effect of putting the depositary in a very awkward position when deciding how to act. It may even prove to be impossible for the depositary to act "fairly" when competing interests of individual investors need to be considered. Finally, the question arises whether the depositary could be subject to overlapping claims in respect of the same loss (i.e. claims by the AIF and the investors in the AIF) and even, in some jurisdictions, to the threat of having to pay compensation twice in respect of the same loss. There is concern that the Commission's Proposal and the Presidency Compromise Texts could be seen as imposing separate and distinct duties of care on the depositary which are owed to the AIF, the investors in the AIF and the AIFM, notwithstanding the nature of the relationship between such entities. This would have the effect of extending the liability of depositaries in a unique and unprecedented manner.

3.1.4.6 The FMLC is aware that similar provisions already exist in Community law where parallel liability is imposed on depositaries vis-à-vis separate and distinct entities (which are contractually related) in respect of the same loss.[46] However, in the case in question, there is one fundamental difference, the depositary's liability is determined in accordance with the national law of the relevant Member State (the "National Law Derogation").[47] It is widely assumed that depositaries can, given this wording, take comfort from Member States' civil liability regimes which may, for example, exclude claims for losses which are merely derivative of losses suffered by the AIF. Establishing the breadth of a depositary's liability is a matter of policy and, therefore, outside the remit of the FMLC. However, to avoid uncertainty in the transposition of the Directive into national law and the confusion that may arise in attempting to create a civil liability regime at the European level which supersedes national civil liability regimes, the FMLC would urge the Council

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46 See Articles 24 and 34 of the UCITS Directive where liability is imposed on the depositary, in certain circumstances, for losses suffered by the management company or investment company (respectively) and the unit-holders.

47 See paragraph 3.1.5 (Liability Regime) below for further analysis of the provisions in the UCITS Directive which provide that the depositary's liability is determined in accordance with the national law of the "UCITS home Member State" or that of the "investment company's home Member State" (as applicable).

of the European Union and the European Parliament to consider adopting a "National Law Derogation" as used previously in Community law.

3.1.5 Liability Regime

3.1.5.1 The liability of the depositary extends to "any losses" suffered by the AIFM or the investors in the AIF as a result of the depositary's failure to perform its obligations.[48] By this provision, the Commission's Proposal seems to intend to create some form of legislative indemnity or liability regime for losses without the usual limiting requirements of foreseeability or proximity. It is unclear how this provision "sits" with Member States' civil liability regimes. In the absence of intentional wrongdoing, the imposition of indefinite liability is unusual as the possible consequences following from a breach of a depositary's duty are endless. In a system of civil liability, holding a depositary responsible for the unpredictable and unforeseeable consequences of its breach may, in the absence of intentional wrongdoing, seem unfair because of a lack of proportionality between the breach and the compensation or damages payable.

3.1.5.2 Professional civil liability is often restricted to liability for fault. Subject to the establishment of factual causation (i.e. the causal link between the defendant's wrongdoing and the harm in respect of which the claimant complains), the concept of "foreseeability" may, in Member States' civil liability regimes, play a threefold role in determining the limits of this fault-based liability.[49] First, it may form part of the test for determining a notional duty of care. In such case, a claimant must come within the compass of foreseeable injury to have a valid cause of action. If the potential for harm is foreseeable in a particular type of relationship, it is likely that there is proximity between the parties and that a notional duty of care will apply to such relationship (the "Notional Duty Limitation"). Secondly, in addition to the requirement of foreseeability of

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48 Article 17(5) of the Commission's Proposal. The scope of this provision has been amended in the Presidency Compromise Texts so that the liability of the depositary is limited to any losses suffered by the AIF other than a loss of financial instruments held in custody which is expressly provided for in Article 17(4b) of the Presidency Compromise Texts.

49 Under English law, the test of foreseeability is not one of actual foresight of the defendant but rather what a court, reviewing the evidence with hindsight and trying to do justice, determines to be foreseeable. See *Clerk & Lindsell on Torts* (The Common Law Library) (Eighteenth Edition, Sweet & Maxwell, London, 2000) 373-374.

damage to the claimant, Member States' civil liability regimes may also require foreseeability of the kind of damage of which the claimant complains. The more foreseeable the particular harm, the greater the obligation on the defendant to avoid such harm by taking precautions against it (the "Careful Behaviour Limitation"). Thirdly, foreseeability may also be seen to limit actionability. A claimant may only be able to recover for damage which is of a kind that is foreseeable (the "Recovery Limitation"). In this third context, the foreseeability of the damage is often referred to as "remoteness of damage". Remoteness tests are concerned with the limits of legal responsibility for damage caused by the defendant and they operate to limit the amount of compensation or damages payable. Where a legal system imposes a civil liability regardless of fault (i.e. a "strict" liability), it is nevertheless common for that liability to be limited by the third and, possibly, the second kind of "foreseeability".[50]

3.1.5.3 It would appear that the intention behind the Commission's Proposal may be to broaden the range of civil liability —or duty of care— relationships such that the Notional Duty Limitation is no longer relevant and proximity between the claimant and defendant is no longer strictly necessary. It would also appear that the intention is to raise the standard of care above the usual fault-based tests of negligence and fraud such that the role of the Careful Behaviour Limitation is significantly reduced and perhaps even removed altogether. However, to go a stage further, and remove the Recovery Limitation would be a very radical step indeed and one that is not likely to be reflected in Member States' existing civil liability regimes.

3.1.5.4 Member States' laws may, as discussed above, confine the depositary's liability to a kind of damage which was a foreseeable consequence of its breach and which was, therefore, proper for it to bear (i.e. those losses which were not considered to be too remote). Clarification is required as to whether it was intended for Article 17(5) of the Commission's Proposal to create the form of legislative indemnity discussed above (i.e. a European liability regime for

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50 Under English law, remoteness tests operate to limit the amount of compensation or damages payable even in the context of a strict liability claim (i.e. where the Notional Duty Limitation is not relevant). See *Cambridge Water Co. v. Eastern Counties Leather Co.* [1994] 2 A.C. 264

all losses including for example all consequential losses), or whether it was intended that the depositaries' obligations should merely be enforced in accordance with each Member State's civil liability regime. If the former is intended, this would be a radical departure from the approach adopted in the Community's financial services legislation to date. The structure and the extent of such liability regime would need to be detailed more fully and the intention to override national liability regimes would also need to be expressly provided for. If the intention is that the depositaries' obligation should be enforced in accordance with each Member State's civil liability regime, then regard should be had to those mechanisms which have been utilised to achieve this result in either the UCITS Directive, the Prospectus Directive or the Transparency Directive (in each case, as discussed more fully below).

3.1.5.5 An important difference between the depositary's liability provision in the UCITS Directive, on the one hand, and the equivalent provision in the Commission's Proposal and the Presidency Compromise Texts, on the other, is that the depositary's liability is, under the UCITS Directive, expressly stated to be determined in accordance with the national law of the "UCITS home Member State"[51] or the "investment company's home Member State"[52] (as applicable). Neither the Commission's Proposal nor the Presidency Compromise Texts provide expressly for the depositaries' obligations to be enforced in accordance with each Member State's civil liability regime and, for that reason, the uncertainties highlighted above become apparent.

3.1.5.6 The Prospectus Directive is another useful comparator. The objective of the Prospectus Directive is to impose a new disclosure obligation on issuers. There is also some suggestion implicit in the recitals that its secondary purpose is to impose a duty of care in respect of the information given in the prospectus, a duty apparently to be owed to prospective investors although this might not be consistent with the Notional Duty Limitation in Member States' civil liability regimes. However, the manner in which this objective is achieved by the Prospectus Directive is instructive. First, the text "speaks"

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51 Article 24 of the UCITS Directive

52 Article 34 of the UCITS Directive

exclusively to Member States rather than the issuers themselves (as is appropriate for legislation in the format of a Directive). It then requires Member States to ensure that responsibility attaches to the issuer and that civil liability attends that responsibility.[53] Secondly, the Prospectus Directive relies upon and preserves the integrity of Member States' existing national laws in ensuring the administrative enforcement of its provisions by providing that:

> Without prejudice to the right of Member States to impose criminal sanctions *and without prejudice to their civil liability regime*, Member States shall ensure, *in conformity with their national law*, that the appropriate administrative measures can be taken or administrative sanctions be imposed against the persons responsible, where the provisions adopted in the implementation of this Directive have not been complied with (emphasis added). [54]

Finally, in so doing, the Prospectus Directive expressly leaves untouched Member States' own civil liability regimes as this excerpt makes clear.

3.1.5.7 Prior to the financial crisis, the high-water mark of the Community's interference in Member States' civil liability regimes in the financial services arena has probably been the Transparency Directive. This directive imposes new disclosure obligations on various persons including issuers and shareholders and does so in language often addressed directly to the duty-holders. However, like the Prospectus Directive, the Transparency Directive only requires Member States to ensure that "their laws, regulations and administrative provisions on liability apply"[55] to the duty holders in question and that penalties are imposed in accordance "with their national law".[56]

3.1.5.8 The FMLC is aware that the Presidency Compromise Texts provide that the "Commission shall adopt implementing measures further specifying……. where there are other losses".[57] However, it is impossible to predict whether or

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53 Article 6(1) and (2) of the Prospectus Directive
54 Article 25 of the Prospectus Directive
55 Article 7 of the Transparency Directive
56 Article 28 of the Transparency Directive
57 Article 17(10) of the Presidency Compromise Texts

not such implementing measures will address any of the concerns highlighted above and therefore the FMLC would welcome further amendments to the Commission's Proposal addressing the uncertainties raised in this regard.

3.1.6 The Abnormal and Unforeseeable Circumstances Defence

3.1.6.1 The Presidency Compromise Texts propose that the depositary shall not be liable

> in cases of abnormal and unforeseeable circumstances beyond the control of the party pleading for the application of those circumstances, the consequences of which would have been unavoidable despite all efforts to the contrary.[58]

In its current form, this defence will be difficult and may even be impossible to rely upon successfully. It has been suggested that the intention may be for the phrase "abnormal and unforeseeable circumstances" to be equated with the doctrine of "force majeure", however the limits of the force majeure doctrine are not in themselves sufficiently clear. The FMLC would, therefore, welcomes clarification as to what is meant by "abnormal and unforeseeable circumstances".

3.1.6.2 Furthermore, the depositary is required to show that the consequences would have been unavoidable despite "all efforts to the contrary" which would appear to involve expenditure of infinite resources and effort by the depositary to satisfy this requirement, effectively undermining the usefulness of the defence. The FMLC proposes that Article 17(7) is amended further so that "reasonable" or "best" is inserted before "efforts to the contrary". A depositary would then only be liable for losses arising out of abnormal and unforeseeable circumstances beyond its control, which would have been avoided if a depositary had attempted on a best or reasonable efforts basis, as applicable, to avoid the loss.

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58 Article 17(7) of the Presidency Compromise Texts

3.1.7 Vicarious Liability

3.1.7.1 The Commission's Proposal provides that the depositary's liability shall not be affected by any delegation of its responsibilities to sub-custodians,[59] which appears to be an attempt to impose a form of vicarious liability on the custodian for the activities of the sub-custodian, although it is uncertain how the New Standard of Care would apply (to the extent not deleted from Article 17 as proposed by the Presidency Compromise Texts) in such cases to the primary custodian or depositary.[60] The imposition of vicarious liability on a depositary for the failures of its sub-custodians[61] and for the failures of the third parties to which its sub-custodian sub-delegates the depositary function[62] would also have the effect of creating pressures and incentives to use sub-custodians that are within the depositary's own corporate group, which would be problematic, *inter alia*, because it is doubtful whether the use of intra-group sub-custodial arrangements are desirable from the point of view of prudential risk management and systemic stability.[63]

3.1.7.2 Insurers are likely to be wary of providing insurance to a depositary against financial loss for breach of its obligations under Article 17 because the risk of breach is high and, to some extent, outside of the depositary's control. If, as a result, depositaries are unable to obtain adequate insurance protection, this would lead to a concentration of risk in the hands of those institutions acting as depositaries under the Directive, which would increase the likelihood of a systemic failure. The question arises whether the systemic "knock-on" implications of the vicarious liability provisions, following the insolvency of a sub-custodian, for the industry and the markets as a whole have been considered.

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59 Article 17(5) of the Commission's Proposal

60 A form of vicarious liability arises in Article 22 and Article 32 of the UCITS Directive where a depositary's liability shall not be affected by the fact that it has entrusted to a third party all or some of the assets in its safe-keeping. Although narrower in its application, the provisions in the UCITS Directive raise similar concerns to those discussed in paragraph 3.1.7.

61 See the express carve-out from liability in Article 17(4b) of the Presidency Compromise Texts which is discussed in paragraph 3.1.2.4 above.

62 See Article 17(4) and 17(5) of the Presidency Compromise Texts

63 See HM Treasury's Consultation Document, "Developing Effective Resolution Arrangements for Investment Banks" (May 2009), in particular paragraphs 3.64-65.

3.2 Verification of Ownership Obligation

3.2.1 In addition to receiving payments made by investors[64] and safe-keeping financial instruments belonging to the AIF, the Commission's Proposal requires a depositary to "verify whether the AIF or the AIFM on behalf of the AIF has obtained the ownership of all other assets the AIF invests in".[65] The parameters of this obligation are, however, fundamentally uncertain.

3.2.2 In order to carry out its obligation to verify ownership, it is unclear from the Commission's Proposal, whether or not, the depositary must actually verify the AIF's or the AIFM's (on behalf of the AIF) legal title to the assets as well as its equitable title thereto. If the obligation is to verify both legal and equitable title, this may prove to be an impractical, complicated and costly if not an impossible task for the depositary. Difficulties may arise in identifying reservations of title to which the assets are subject which are not disclosed by the vendor or identifying security interests which are not registered or otherwise publicly documented. Any failure by the depositary to identify third party rights granted in respect of the AIF's or AIFM's (on behalf of the AIF) assets would cause the depositary to breach its verification of ownership obligation.

3.2.3 Alternatively, it has been suggested that the verification requirement is intended to capture derivatives and stock lending arrangements where the asset is not normally held by the depositary such that, perhaps, the provision obliges the depositary to "verify" the enforceability of any contractual arrangement for the return of the asset after the asset has been "lent" or used as collateral under a title transfer arrangement into which the AIF has entered through the medium of the custodian's agency. This obligation, however, cannot be read clearly in the provision and seems to be unfairly onerous, at least in those cases where the depositary is not acting as an agent in the AIF's contractual arrangements.

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64 The FMLC understands that for those AIFs that currently have a depositary or something akin to it, it is not unusual for the depositary to hold the account into which subscription/redemption money is paid. Such account would normally be controlled and monitored by the AIFM as opposed to the depositary. The Presidency Compromise Texts imply that the depositary should be carrying out the role of the AIFM in looking after the subscription/redemption process. To reflect market practice whilst ensuring that the policy objective is equally well served, it may be worth replacing such function with an oversight requirement on the depositary which would be closer to the way the process normally operates for those AIFs that have a depositary.

65 Article 17(1) of the Commission's Proposal

3.2.4 The FMLC is aware that the Presidency Compromise Texts propose substantial amendments to Article 17 which address the concerns highlighted above. The Presidency Compromise Texts provide that the depositary must "verify whether the AIF or the AIFM on behalf of the AIF holds an ownership interest in all other assets the AIF invests in".[66] The Presidency Compromise Texts also clarify the depositary's obligation, which is now limited to identifying an "ownership interest", legal or equitable. However, concerns still arise as to whether depositaries will have access to the information necessary for them to verify ownership of assets that are not even in their custody and also as to whether or not they will even be aware of the existence of such assets, in respect of which they are obliged to verify the AIF's or AIFM's ownership.

3.2.5 Further clarification is also required on the operation of Article 17(1)(c) generally. Neither the Commission's Proposal nor the Presidency Compromise Texts dictate when the depositary should carry out such verification of ownership, how frequently the depositary should undertake this function or even within what timeframe such verification should occur. The texts are also silent on what the consequences are in the event that the depositary cannot verify the AIF or the AIFM (on behalf of the AIF) as the owner of such assets within a particular time-frame or at all.

3.2.6 Verification of ownership is not a requirement which applies under the UCITS Directive to a depositary appointed to a UCITS; and, since depositaries may not actually be able to identify some third-party rights as set out above, depositaries will have difficulties in ensuring compliance with the verification of ownership obligation. On the basis of the above, the FMLC would recommend the removal of the verification of ownership obligation from the Commission's Proposal.

3.3 Delegation Restriction on Depositaries

3.3.1 The provisions of the Commission's Proposal which relate to the appointment of depositaries[67] and the delegation of depositary functions to sub-custodians would have a number of other very significant effects, which do not appear to

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66 Article 17(1)(c) of the Presidency Compromise Texts

67 Article 17(3) of the Commission's Proposal

have been intended by the European Commission. They would prevent AIFs from investing in a number of markets where the use of a local sub-custodian is either mandatory[68] or a necessary by-product of the need to secure experts in local market practices as, under Article 17, depositaries would be unable to delegate their functions to sub-custodians which are not EU credit institutions.[69]

3.3.2 The Presidency Compromise Texts address these concerns and the FMLC welcomes these developments. The Final Swedish Presidency Text provides that any of the following may be a depositary for the purposes of the Directive:

(A) a credit institution authorised under Directive 2006/48/EC relating to the taking up and pursuit of business of credit institutions;

(B) an investment firm authorised under Directive 2004/39/EC[70] on markets in financial instruments ("MiFID") to provide the ancillary services of safe-keeping and administration of financial instruments and having its registered office in the Community; or

(C) a legal person, authorised by the competent authorities of the home Member State of the AIFM to act as a depositary, which is subject to prudential regulation and ongoing supervision and which can furnish sufficient financial and professional guarantees to be able to effectively perform the relevant depositary functions and meet the commitments inherent in those functions.[71]

3.3.3 In addition to the above, each of the Presidency Compromise Texts provide that where an AIF has no assets which can be safe-kept, the depositary may be an entity which carries out depositary functions as part of its professional or business activities provided that it is subject to mandatory professional registration recognised by law or to legal or regulatory provisions or rules of

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68 In various emerging economies, and even in certain G8 countries such as Japan, the use of local sub-custodians is mandatory in respect of domestic securities.

69 The depositary is required to be an EU credit institution under Article 17(3) of the Commission's Proposal and, since the right of the depositary to delegate is expressed in Article 17(4) of the Commission's Proposal as a right to delegate to "other depositaries", the implication is that the sub-custodians must also be EU credit institutions.

70 OJ L 145, 30.4.2004

71 Article 17(3) of the Final Swedish Presidency Text

professional conduct and can furnish similar guarantees to those mentioned in (C) above.[72]

3.3.4 The Commission's Proposal expressly allows depositaries to delegate their tasks to other depositaries.[73] However, the Presidency Compromise Texts restrict the depositary's delegation rights.[74] The depositary is, under the Presidency Compromise Texts, merely authorised to delegate its safe-keeping of financial instruments function and its verification of ownership function. Any delegation by the depositary of (A) the functions set out in Article 17(1a) of the Presidency Compromise Texts; (B) any corporate action functions; or (C) any other custody related services (other than the safe-keeping and verification of ownership functions) appears, albeit illogically, to be prohibited by the Presidency Compromise Texts.

3.3.5 The CREST system operated by Euroclear UK & Ireland provides corporate action services and other custody related services and is often used by depositaries. The Presidency Compromise Texts raise the question as to how far third-party assistance can be obtained by the depositary without it amounting to delegation. Clarification is required as to whether depositaries are permitted to delegate corporate action services or custody related services other than those functions of the depositary identified in Article 17(4) of the Presidency Compromise Texts. In addition, as a matter of market practice, foreign banks and insurance companies are often required to deal with CREST through a local or global custodian. This requirement raises an additional question as to whether delegations of necessity by the depositary should also be subject to the same regulatory requirements as all other acts of delegation.

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72 Article 17(3) of the Presidency Compromise Texts

73 Article 17(4) of the Commission's Proposal

74 Article 17(4) of the Presidency Compromise Texts

4. INCONSISTENCIES AND CONFLICTS BETWEEN THE COMMISSION'S PROPOSAL AND EXISTING FINANCIAL SERVICES DIRECTIVES

4.1 Overview

4.1.1 The Commission's Proposal operates, at times, in stark contrast to the provisions of existing Community legislation, particularly the Transparency Directive and the Prospectus Directive. Legislative provisions with similar, if not identical, objectives are not wholly co-extensive and such variations give rise to significant inconsistency in the application of Community legislation and, in the case of paragraph 4.1.2(C) below, to legal uncertainty. A contributory factor has been the use of the UCITS Directive as a precedent for some of the key provisions in the Commission's Proposal. Regard has not been given to the fact that the field of application of the UCITS Directive and that of the Prospectus Directive/Transparency Directive are mutually exclusive.[75] The Directive, however, will operate in conjunction with the Prospectus Directive and the Transparency Directive as the AIFs themselves may be subject to the Prospectus Directive and the Transparency Directive whilst their managers will be subject to the Directive. It is, therefore, imperative that in drafting the Directive due consideration is given to the provisions in the Prospectus Directive and the Transparency Directive so that the Directive creates a legislative framework applicable to AIFMs which makes full use of, and is compatible with, the Community's existing regulatory framework. The alternative would merely result in a fragmented regulatory patchwork at the European level which would not be helpful to the long-term objective of creating a secure and sustainable regulatory environment throughout Europe.

4.1.2 The following are specific illustrations of current inconsistencies between the Commission's Proposal and the existing provisions of the Prospectus Directive and the Transparency Directive and each are discussed, in turn, further below:

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75 The UCITS Directive applies to collective investment undertakings in transferable securities of the open-ended type whilst the Prospectus Directive and the Transparency Directive apply only to collective investment undertakings of the closed-ended type.

(A) Investor protection related disclosure obligations of (i) AIFs under the Prospectus Directive and (ii) AIFMs under the Commission's Proposal;

(B) Financial reporting obligations of (i) AIFs under the Transparency Directive and (ii) AIFMs under the Commission's Proposal; and

(C) Shareholding-related disclosure obligations of (i) AIFs under the Transparency Directive and (ii) AIFMs under the Commission's Proposal.

4.2 Investor Protection Related Disclosure Obligations

4.2.1 With the intention of ensuring an appropriate level of investor protection, the Commission's Proposal sets down minimum disclosure requirements with which the AIFM must comply on an initial basis, prior to investors investing in an AIF which the AIFM manages, and on an on-going basis by keeping investors up to date with any changes to information previously disclosed. The AIFM is required to provide AIF investors with, *inter alia*, a clear description of the investment policy of the AIF and a description of the procedures by which the AIF may change its investment strategy and policy, the identity of key service providers to the AIF such as the depositary and the valuator and a description of all fees, charges and expenses which are directly or indirectly borne by investors.[76]

4.2.2 Subject to limited exemptions, the Prospectus Directive, in a similar attempt to protect investors, requires a prospectus to be published when securities are offered for sale to the public or admitted to trading on a regulated market situated in or operating within a Member State.[77] The Prospectus Directive acknowledges "that information is a key factor in investor protection"[78] and prescribes that the prospectus should contain all information necessary to enable investors to make an informed investment decision including the risks associated with the issuer and the securities and the characteristics of the securities.[79] The

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76 Article 20 of the Commission's Proposal
77 Article 3(1) of the Prospectus Directive
78 Recital (21) of the Prospectus Directive
79 Article 5(1) and (2) of the Prospectus Directive

Prospectus Directive applies to units issued by collective investment undertakings of the closed-end type which are offered to the public or admitted to trading on a regulated market in the Community.

4.2.3 In obliging the AIFM to make the disclosures set out in Article 20, the Commission's Proposal does not even have regard to the investor protections established by the Prospectus Directive. To ensure that the principle of investor protection is applied consistently across the Community, the FMLC would recommend that the Directive should work in tandem with the Prospectus Directive so that where an AIF has produced a prospectus in compliance with the Prospectus Directive, the AIFM should merely be obliged to provide investors with that prospectus prior to their initial investment. Similarly, when the AIF updates the prospectus in accordance with Article 16 of the Prospectus Directive, the AIFM should ensure that the supplements are forwarded to the AIF's investors.

4.2.4 The Presidency Compromise Texts expressly refer to prospectuses published in accordance with the Prospectus Directive and only obliges the AIFM to disclose, separately or as additional information in the prospectus, the information required by Article 20 which is not contained in the Prospectus Directive compliant prospectus. This piecemeal approach to investor protection across Community legislation creates an unnecessarily complicated legal framework which leads inevitably to inconsistencies in the application of Community legislation. To the extent that the legislative intention in the Commission's Proposal and the Presidency Compromise Texts is to bolster investor protection, amendments should be made simultaneously to the Prospectus Directive to bring the disclosure requirements therein in line with those set out in the Directive.[80] The Directive should then support the obligations imposed by the Prospectus Directive and supplement them only in the restricted manner described in paragraph 4.2.3 above.

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80 A Commission proposal to amend the Prospectus Directive, for reasons unrelated to the Directive, is currently awaiting co-decision.

4.3 Annual Financial Reporting Obligations

4.3.1 Chapter IV (*Transparency requirements*) of the Commission's Proposal requires an AIFM to make available, for each AIF it manages, an annual report for each financial year which shall be made available to investors and competent authorities no later than four months following the end of the financial year.[81] The annual report must include, *inter alia*, an income and expenditure account for the financial year and a report on the activities of the financial year[82] and any accounting information given in the annual report must be audited.[83]

4.3.2 AIFs, to the extent that their fund shares or units are traded on a regulated market,[84] are obliged under the Transparency Directive to make public their annual financial report, at the latest, four months after the end of each financial year.[85] The annual financial report shall include, *inter alia*, the audited financial statements of the AIF.

4.3.3 To maintain the integrity of the financial services legislative framework in the Community and to avoid inconsistency in the application of Community legislation, the Directive should consider and take account of the AIFs' existing obligations (if any) under the Transparency Directive. To do this in a complementary fashion, the FMLC is of the view that the AIFM should not be obliged, in the Directive, to make available annual reports containing information that would not ordinarily be found in the annual financial reports produced by the AIFs themselves. The AIFM should, therefore, merely be obliged to forward on, to its own competent authority and any other intended recipients, the annual financial reports as published by the AIFs.

4.3.4 The Presidency Compromise Texts acknowledge that an AIF may be obliged to publish annual financial reports when complying with the requirements of the

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81 Article 19(1) of the Commission's Proposal
82 Article 19(2) of the Commission's Proposal
83 Article 19(3) of the Commission's Proposal
84 Regulated market has the meaning given to such term in MiFID.
85 Article 4(1) of the Transparency Directive

Transparency Directive[86] but still they require the AIFM to provide such additional information as is necessary to ensure that the annual report contains each of the items listed in Article 19(2). Rather than imposing, under different aspects of Community legislation, inconsistent financial reporting obligations on the AIF and the AIFM (in respect of the AIFs that it manages), the FMLC recommends that uniformity is promoted across the Community and suggests that this can be achieved by aligning the AIFs' financial reporting obligations under the Transparency Directive with those of the AIFM (with respect to the AIFs that it manages) under the Directive.

4.4 Information about Major Holdings

4.4.1 The Commission's Proposal imposes notification and/or disclosure obligations on the AIFM in the event that the AIFM:

(A) manages one or more AIF which either individually or in aggregation acquire 30% or more of the voting rights of an issuer[87] or of a non-listed company domiciled in the Community; or

(B) has entered into an arrangement with one or more other AIFM which would allow the AIF managed by such AIFMs to acquire 30% or more of the voting rights of the Issuer or the non-listed company.[88]

In these circumstances the AIFM is deemed to have obtained a controlling influence in an investee company, indirectly, through the relevant AIF(s) that it manages. When this occurs, the AIFM is obliged to notify non-listed companies and all other shareholders as soon as possible but no later than four trading days after the AIFM has reached this position.[89] This initial notification requirement does not extend to any situation in which the AIFM has obtained a controlling influence in an Issuer. The AIFM's disclosure obligations are set out in Articles

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86 Article 19(1) of the Presidency Compromise Texts

87 An issuer is defined in the Commission's Proposal as a legal entity governed by private or public law, including a State, whose securities are admitted to trading on a regulated market and being, in the case of depository receipts representing securities, the issuer of the securities represented. The Presidency Compromise Texts expand the definition further by requiring the issuer (hereafter, the "Issuer") to be domiciled in the Community and have its shares admitted to trading on a regulated market as defined in Article 14 of MiFID.

88 Article 26 of the Commission's Proposal

89 Article 27(1) of the Commission's Proposal

28 and 29 of the Commission's Proposal and they apply where an AIFM has obtained a controlling influence in either a non-listed company or an Issuer.

4.4.2 The FMLC is aware that a controlling influence over a company can be exerted by AIFMs through their management of multiple AIFs and that the Directive may be the most appropriate place to address this issue through the "aggregation" of their shareholdings.[90] It is, however, not entirely clear why the initial notification requirement applies only to AIFMs to the extent that they have obtained a controlling interest in a non-listed company. It would seem equally as important for shareholders in listed companies to be notified when an AIFM has recently obtained a controlling interest therein. Investors in listed companies may be able to see when an individual AIF has acquired a controlling interest by scrutinising the listings but will not necessarily be aware when an AIFM has acquired control by reason of an "aggregation" of shareholdings through various AIFs. There is some question whether voting rights and shareholdings in listed companies are already covered by the "aggregation" provisions of the Transparency Directive.[91] However, these provisions are notoriously difficult to follow and lack clarity in their application to AIFMs. It would be a pity if this lack of clarity was perpetuated in the Directive by default or by implication.

4.4.3 The disclosure obligations imposed on AIFMs in Article 28 are wide-ranging and extend beyond the information required in offer documents for takeover bids as set out in Directive 2004/25/EC on takeover bids (the "Takeover Bid Directive"). To ensure the consistent application of Community legislation, the

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90 Whilst there is no express general requirement in the Transparency Directive for persons who are subject to a duty of disclosure vis-à-vis the issuer to "aggregate" any voting rights acquired through separate shareholdings, the question arises as to whether this result is achieved by Article 10, in most cases. In practice, market practitioners interpret the Transparency Directive purposively and although Article 10 is difficult to apply literally to fund managers, AIFMs typically report, on an aggregate basis, the voting rights which they control in respect of shares held for different underlying funds. (Article 9 of the Transparency Directive imposes notification requirements on shareholders in the event that they, as a result of an acquisition or disposal, hold a proportion of voting rights which reaches, exceeds or falls below specified thresholds. Article 10 of the Transparency Directive applies the Article 9 notification requirements to a natural person or legal entity to the extent that it is entitled to acquire, dispose of or exercise voting rights in a specific set of circumstances.) From an English law perspective, this purposive interpretation of Article 10 is supported by the Financial Services Authority's Disclosure and Transparency Rules. Worthy of note are DTR 5.2.2 and DTR 5.2.3 (accessible on http://fsahandbook.info/FSA/html/handbook/DTR). DTR 5.2.2 provides, *inter alia*, guidance on Article 10(h) of the Transparency Directive and indicates that although referring to proxies, Article 10(h) describes and applies to (i) a person undertaking investment management and (ii) a management company, in each case which is effectively able to determine the manner in which voting rights attached to shares under its control are exercised. DTR 5.2.3 provides that a person falling within Article 10(a) to (h) of the Transparency Directive is an indirect holder of shares for the purposes of the definition of shareholder and that these indirect holdings have to be aggregated and separately identified in a notification to the issuer.

91 *Ibid.*

FMLC recommends that any additional non-AIFM-specific disclosure obligations (e.g. any obligation to disclose policy for external and internal communication of the Issuer in particular as regards employees) should be dealt with by means of an amendment to the Takeover Bid Directive.

4.4.4 Article 30 of the Commission's Proposal provides that if, following an acquisition of 30% or more of the voting rights of an Issuer, the shares of that Issuer are no longer admitted to trading on a regulated market, the Issuer shall continue to comply with the provisions of the Transparency Directive for two years from the date of delisting (the "Delisting Requirement").

4.4.5 The Transparency Directive requires AIFs (as shareholders, who acquire or dispose of shares of an issuer which are admitted to trading on a regulated market and to which voting rights are attached) to notify issuers of the proportion of voting rights held by the AIF as a result of an acquisition or disposal where that proportion reaches, exceeds or falls below specified thresholds; 30% and 75% are two of eight different thresholds identified.[92] Article 9(3) of the Transparency Directive provides that Member States need not apply the 30% threshold or the 75% threshold, in circumstances where they apply a threshold of one-third and two-thirds, respectively. Furthermore, an exemption to such notification/disclosure obligations exists in the Transparency Directive for shares acquired solely for fulfilling settlement obligations and for shares held by a custodian. [93]

4.4.6 Clarification is required to understand the inter-relation between the AIFM's notification and disclosure duties under Chapter V (*Obligations regarding AIFM managing specific types of AIF*) of the Commission's Proposal and the AIF's notification and disclosure obligations under Section 1 of Chapter III (*Information about major holdings*) of the Transparency Directive. One particular inconsistency is the notification and/or disclosure obligation which arises under the Commission's Proposal when an AIFM obtains a controlling interest or has entered into an agreement whereby it will indirectly (through the

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92 Article 9 of the Transparency Directive

93 Article 9(4) of the Transparency Directive

AIFs that it manages) acquire 30% or more of the voting rights in a company. An individual AIF may not, where a Member State has applied a threshold of one-third, have to make any corresponding disclosures under the Transparency Directive to the extent that it increases its shareholding from 25% to a holding which is less than 33.3%. Another inconsistency worth noting is the existence of a short-selling exemption in the Transparency Directive which is not catered for in the Commission's Proposal.

4.4.7 Whilst it is not for the FMLC to comment on issues of policy, requiring private equity firms to comply with the disclosure obligations of Chapter V of the Commission's Proposal (to whom it is self-evidently addressed) appears to be inequitable as such obligations do not apply to other private buyers which are not AIFs (e.g. high net worth individuals or funds which are not collective investment undertakings). It seems doubtful that the Community intends to create different regulatory regimes for different categories of shareholders as any such initiative would have a market-distorting effect. Unless this apparent inequity is resolved or the initiative justified, say, in the recitals, then the doubt highlighted above may undermine efforts by AIFMs and, ultimately, by courts to settle on a satisfactory purposive interpretation of the new provisions.

4.4.8 The Presidency Compromise Texts propose amendments to Articles 26, 27, 28 and 29 of the Commission's Proposal which, if adopted, would only require AIFMs to comply with the notification and disclosure requirements set out therein in circumstances where the AIFM had reached a position or had entered into an agreement whereby it would reach a position in which it could exercise *50%* of the voting rights in a *non-listed company*. No distinction is drawn between listed and non-listed companies in the corresponding provisions of the Transparency Directive and clarification as to the Directive's legislative intention would be most welcome in this regard.

4.4.9 The disclosure obligations imposed on AIFMs in Article 28 of the Presidency Compromise Texts are not as wide-ranging as those set out in the Commission's Proposal and no longer extend to non-AIFM-specific disclosure obligations. The Presidency Compromise Texts also propose the removal of the Delisting Requirement. The FMLC welcomes these proposed amendments.

(B) ISSUES SUBSTANTIALLY ADDRESSED BY THE PRESIDENCY COMPROMISE TEXTS

5. DELEGATION RESTRICTION ON AIFMS

5.1 Under Article 18 of the Commission's Proposal, any delegation by an AIFM of any of its functions will require the prior authorisation of the regulatory authorities in its home EU Member State. Any such delegation must comply with certain conditions. In particular, where the delegation is of portfolio management or risk management, the third party to whom the function is delegated must itself be authorised as an AIFM to manage an AIF of the same type. These provisions are uncertain in a number of respects.

5.2 It is not clear whether the reference to an AIFM in Article 18(1)(b) means an AIFM authorised under the Directive, or whether it includes a fund manager regulated at national Member State level. The provisions also seem at odds with the structures of many funds that fall within the scope of the Commission's Proposal, in that they would appear to prevent an AIFM from delegating part of its management services to a specialist. It may be highly desirable for a real estate fund to delegate real estate management to a specialist, but real estate management is not of itself regulated in any Member State, or under the Commission's Proposal. Equally, an AIFM may be prevented from delegating part or all of the portfolio management function to an investment manager which is a specialist in a particular practice area, such as emerging markets or in a particular non-EU based jurisdiction but which is not based in the EU and thus not subject to, or capable of being authorised in, the EU.

5.3 The drafting of these provisions is a cause of particular concern for the existing business model of a "manager of managers fund" (an "MOM Fund") as the investment strategy of an MOM Fund involves the appointment of different investment managers and, in many circumstances, such investment managers would not be based in or authorised in the EU. The established business model of the MOM Fund is not explicitly contemplated in Article 18 of the Commission's Proposal and it is not clear whether or not the application of Article 18 to MOM Funds is intentional or inadvertent.

5.4 The Presidency Compromise Texts address each of the above concerns by deleting the reference to an AIFM in Article 18(1)(b) and by expressly permitting AIFMs to delegate the portfolio and risk management functions to:

(A) those undertakings which are authorised or registered for the purpose of asset management and subject to supervision; or

(B) those undertakings to whom prior authorisation has been granted by the competent authorities of the home Member State,

provided that where the undertaking is a third-country undertaking co-operation between the competent authorities of the home Member State and the supervisory authority of the third-country undertaking is ensured.[94] It is presumed that the references to "home Member State" in Article 18(1)(b) and (ba) of the Presidency Compromise Texts are to the home Member State of the relevant AIFM, however, express clarification is needed in the Directive to this effect.

5.5 In addition, no distinction is made in the Commission's Proposal or in the Presidency Compromise Texts between the delegation of decision making functions by the AIFM and the delegation of administrative or purely operational functions (e.g. the use of an executing broker to finalise and process orders on behalf of the AIF) and, therefore, a literal interpretation of Article 18 would suggest that all such delegations are caught, although there is no certainty as to whether this is an intended effect. Clarification would be welcomed for the purposes of ascertaining which functions of the AIFM, if any, are not subject to the restrictions on delegation.[95]

5.6 It should also be clarified in the Commission's Proposal whether the delegation of marketing units in an AIF by the AIFM to a MiFID authorised placement agent is a delegation which would require pre-approval under the provisions of Article 18 or whether it is already permitted in accordance with Recital 5 (which states that MiFID authorised investment firms are permitted to provide

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94 Article 18(1)(b) and (ba) of the Presidency Compromise Texts

95 See paragraph 2.3 (Administration – Regulated Activity or Unregulated Activity?) above

investment services in respect of an AIF without requiring separate authorisation under the Directive). The Presidency Compromise Texts do not expressly address this point. Each texts merely identify "portfolio management" as an investment service which a MiFID authorised investment firm is permitted to undertake without being required to obtain an authorisation under the Directive.[96]

6. GRANDFATHERING / SIDE LETTERS

6.1 The Commission's Proposal 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.[97] However, neither of these obligations includes any concept of materiality. As a result, there is a putative requirement that even non-material terms of side letters, which are not relevant to other investors, be disclosed.

6.2 It is understandable that an AIF should disclose to investors that it has the authority to enter into side letters and that the terms of side letters that are material to other investors in AIFs should be periodically disclosed to those investors. However, the obligations to disclose the identity of investors and non-material side letter terms seems unnecessarily burdensome and, perhaps, an unintended consequence of the provisions set out in the Commission's Proposal.

6.3 Article 9(1) of the Commission's Proposal also provides that:

> No investor may obtain preferential treatment, unless *this* is disclosed in the AIF rules or instruments of incorporation (emphasis added).

Greater precision is required to understand the nature of the underlying disclosure obligation. Grammatically, the reference to "this" is confusing. It is not clear whether the requirement is for the AIF's rules or instruments of incorporation to:

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96 Recital 5c of the Presidency Compromise Texts

97 Article 20(1)(i) of the Commission's Proposal

(A) contain general details of the AIF's authority to grant preferential treatment;

(B) identify the types of preferential treatment that may be granted;

(C) set out the conditions for granting such preferential treatment; and/or

(D) identify the criteria (if any) which needs to be complied with when granting such preferential treatment.

6.4 Article 9(1) is silent as to what the AIF's rules or instruments of incorporation need to contain. Another possible interpretation is that, prior to any investor receiving preferential treatment, the AIF's rules or instruments of incorporation must be amended so that they contain specific details of the preferential treatment being granted on a case by case basis. Such an interpretation gives rise to a disclosure obligation which seems improbably burdensome. Therefore, the FMLC assumes that the intention in Article 9(1) is to impose a requirement for generic disclosure in the AIF's rules or instruments of incorporation of the preferential treatment which may be granted by the AIF and the circumstances in which such preferential treatment may be granted. In either case, Article 9(1) requires further amendment so that AIFs fully understand the nature of their underlying disclosure obligations.

6.5 The restriction on investors obtaining preferential treatment remains unchanged in Article 9(1) of the Presidency Compromise Texts although the disclosure obligations as set out in Article 20(1)(i) have been amended in the Presidency Compromise Texts. Whilst the AIFM is still obliged to provide investors, prior to their initial investment, with a description of the preferential treatment or of the right to preferential treatment which other investors have obtained, the AIFM is no longer required to disclose the *identity* of those investors who have obtained such preferential treatment or the right to such preferential treatment. The FMLC hopes that progress will also be made on the remaining issues of concern highlighted above.

6.6 Moreover, there is bound to be uncertainty among established funds as to whether the terms of pre-existing confidential side letters must be disclosed once

the Directive comes into force and, if so, to what extent such disclosure must be made in the AIF rules or instruments of incorporation. This question throws into relief the difficulty that will be experienced by some established funds in adapting to the requirements of the Commission's Proposal given the absence of any "grandfathering" provisions.

7. LEVERAGE

7.1 A number of provisions in the Commission's Proposal refer to an AIF being "leveraged". The concept of leverage is defined in Article 3(1) as any method by which an AIF's exposure to a "particular investment" is increased through the borrowing of cash or securities, through derivative positions or by any other means. In fact, commercial AIFs are not likely to borrow in respect of a particular investment and even less common is the activity of borrowing simply to increase exposure to one particular *pre-existing* investment. The FMLC notes that the Presidency Compromise Texts address this issue by deleting the reference to "a particular investment" in the definition of leverage[98] and the FMLC is of the view that these revisions represent a useful attempt to reflect accurately current market practice.

7.2 Where the investors in the AIF make part or all of their investment by way of a loan or other financing, the FMLC presumes that such investment should not be regarded as leverage for the purposes of the Directive. Certainty as to the legislative intention in this regard is particularly important for the standard private equity partnership which technically classifies almost the whole investment as "loan commitment" rather than "capital commitment".

7.3 Leverage is a technical term used across the wholesale financial markets which lacks a stable technical meaning. In practice, it is both defined and calculated differently by investment banks and fund managers. Importance attaches to the definition of leverage throughout the Commission's Proposal and the Presidency Compromise Texts. At the outset, when determining the scope and application of the Directive, leverage is of utmost importance and needs to be considered to ascertain if an AIFM falls within the Threshold Exemption. The inherent

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98 Article 3(1)(l) of the Presidency Compromise Texts

uncertainty as to the meaning of this fundamental term could seriously hinder the effectiveness of the Threshold Exemption and, to the extent that clarification cannot be provided, the abolition of the Threshold Exemption may need to be considered.[99]

7.4 The Commission's Proposal contains a provision which requires that the European Commission, "in order to ensure the stability and integrity of the financial system", adopt measures setting limits to the level of leverage which an AIFM can employ, taking into account "*inter alia*, the type of AIF, their strategies and the sources of their leverage".[100] The Preamble suggests that such limits could either consist of a threshold that should not be breached at any time or a limit on average leverage employed during a given period (such as monthly or quarterly). In either case, it may not be possible for AIFMs to predict with any accuracy the limits the European Commission might set, which will result in considerable operational uncertainty for the AIFMs and, ultimately, for the AIF investors.

7.5 Whilst the FMLC is not in a position, given its remit, to object to the introduction of such leverage limits, it is tentatively of the view that it would be more appropriate for such limits to be determined by the competent authorities of the home Member States (as such authorities work closely with the AIFs and the AIFMs and are thereby familiar with the markets in which they operate) under the supervision of the Committee of European Securities Regulators ("CESR") which could be tasked with the role of co-ordinating such leverage limits across the Community. If leverage limits are to be established, legal certainty requires that such limits are set out clearly and they must be sensitive to the ever-changing market conditions in which the AIFs and AIFMs operate, otherwise such limits could either damage the market or fail to achieve their objective. The FMLC is reluctant to endorse any bifurcation of the role for determining applicable leverage limits between the European Commission and the competent authorities of the home Member States as such bifurcation could lead to confusion and uncertainty in the application of such leverage limits.

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99 See paragraph 2.6 (Threshold Exemption) above

100 Article 25(3) of the Commission's Proposal

7.6 The Presidency Compromise Texts propose that the competent authorities of the home Member State of the AIFM, as opposed to the European Commission, impose such leverage limits and duly inform the competent authorities of the home Member State of the AIF and CESR of actions taken in this regard.[101] The FMLC supports this proposal.

8. NATIONAL PRIVATE PLACEMENT REGIMES

The Presidency Compromise Texts have considered the importance of national private placement regimes and provide that Member States may allow, or continue to allow, AIFMs to market AIFs established in third countries to professional investors on their territory subject to national law.[102] The FMLC understands that such a development is likely to be welcomed by financial market participants as it enables national regulators to meet the needs of the national markets. To avoid confusion and uncertainty, the FMLC considers Chapter VII (*Specific rules in relation to third countries*) to be the most appropriate place for the inclusion of such a provision.

9. THE INTERNATIONAL STANDARDS REQUIREMENT FOR MANAGING NON-EU AIFS

9.1 The Presidency Compromise Texts propose new restrictions on authorised AIFMs' ability to manage AIFs established in countries outside the EU.[103] In particular, the requirements are that:

(A) the third country would need to have legislation in place which is in line with the standards set by international organisations or the AIFM would need to be able to demonstrate that the AIF in the third country complies with these standards (the "International Standards Requirement"); and

(B) appropriate cooperation arrangements are in place between the competent authorities of the home Member State of the AIFM and the supervisory authority of the third country where the AIF is established.

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101 Article 25(3a) of the Presidency Compromise Texts

102 Recital 19 and Article 31(4a) of the Presidency Compromise Texts

103 Article 34a of the Presidency Compromise Texts

9.2 The manner in which the International Standards Requirement will be applied is not dealt with explicitly in the Presidency Compromise Texts. It is not clear whether the legislation of the third country has to be in line with the standards set by all international organisations identified in the European Commission's implementing measures[104] or solely with the standards of one of the identified organisations. The Presidency Compromise Texts are silent with respect to which set of standards the third party country should comply in the event of any inherent inconsistency between the standards set by the different international organisations identified in the European Commission's implementing measures. In addition, no guidance is provided as to whether a third country can go in and out of "compliant" status in the event that either the list of international organisations identified in the European Commission's implementing measures or the international standards themselves change from time to time.

9.3 In order to ensure the uniform application of Article 34a across the Community, the Final Swedish Presidency Text provides that CESR shall develop guidelines to determine the conditions of application of the implementing measures adopted by the European Commission with respect to the International Standards Requirement.[105] Whilst CESR's guidelines or the European Commission's implementing measures themselves may address the above concerns, this is impossible to predict with any degree of certainty. Therefore, the FMLC would welcome further amendments to the Directive addressing these uncertainties. The FMLC also recommends that the implementing measures are drafted flexibly to ensure that any list of international organisations and their associated standards do not fast become obsolete.

10. EQUIVALENCE REQUIREMENT ON MARKETING BY NON-EU FUNDS

10.1 The Commission's Proposal provides that EU Member States may authorise AIFMs which are not established in an EU Member State to market shares of a

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104 Article 34a(2) of the Presidency Compromise Texts

105 Article 34a(3) of the Final Swedish Presidency Text

non-EU fund to professional investors throughout the EU, provided, *inter alia*, that:[106]

(A) the non-EU country's "legislation regarding prudential regulation and ongoing supervision is equivalent to the provisions of th[e] Directive and is effectively enforced" (the "Equivalence Requirement"); and

(B) the non-EU country grants EU AIFM "effective market access comparable to that granted by the Community to AIFM[s] from that third country" (the "Market Access Requirement").

This provision was originally intended to take effect three years after the entry into force of the Directive.[107]

10.2 If equivalence is taken to require substantively identical provisions rather than a more flexible approach to regulation which has substantively equivalent goals, it may be extremely difficult, if not impossible, in practice to satisfy these conditions. Legal and regulatory equivalence with the terms of the Commission's Proposal or with the prudential rules laid down in Community law generally is likely to be rare in overseas jurisdictions. Whilst, for example, the Obama Administration in the US has put forward legislation to increase the regulation of investment advisers of private funds, this would nevertheless represent a "lighter touch" regime than that proposed under the Commission's Proposal.[108] It is also highly unlikely that any emerging market would be able to satisfy the Equivalence Requirement. Equally, the failure by the US and EU regulators to agree to reciprocal access for UCITS funds and their US

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106 Article 39 of the Commission's Proposal

107 Article 54(1) of the Commission's Proposal

108 On 15 July 2009, the US Department of the Treasury delivered to the US Congress the Private Fund Investment Advisers Registration Act 2009, which would, among other things, require certain advisers to private investment funds to register as "investment advisers" with the US Securities and Exchange Commission ("SEC") under the US Investment Advisers Act 1940 as amended (the "Advisers Act"). Registration under the Advisers Act would subject presently unregistered investment advisers to the full panoply of the requirements of the Advisers Act and regulations thereunder, including with regard to: advisory contracts; advisory fees; fiduciary duties and standards of care to clients; disclosure to clients and regulators; custody and possession of client assets; recordkeeping; advertising; trading and investment practices; supervision, compliance and code of ethics practices, policies, and procedures; use of solicitors and placement agents; and SEC inspections, discipline, and disqualification.

equivalent, over a number of years, demonstrates how difficult it may prove to satisfy the Market Access Requirement.[109]

10.3 The FMLC is aware that the Presidency Compromise Texts propose the deletion of Article 39 (*Authorisation of AIFM established in third countries*) and propose that the EU-wide passport is restricted to EU-established AIFs, which are marketed to professional investors by authorised AIFMs. Unless further clarification of the Equivalence Requirement and the Market Access Requirement can be provided in the Directive, the FMLC believes that the removal of these confusing standards is desirable from a legal certainty perspective. The question of whether these very restrictive provisions on "passporting" are appropriate from a policy perspective is one for consideration by the Council of the European Union and the European Parliament.

11. CONCLUSION

11.1 It is not the role of this Committee to comment on policy questions in relation to the substance or application of regulatory requirements imposed on AIFMs. This paper is intended to assist those involved in the policy decisions by drawing attention to the most significant elements of legal uncertainty that arise out of the Commission's Proposal and the Presidency Compromise Texts.

11.2 It is essential, if the Directive is to be successful, that there is no doubt as to its scope in order to avoid uneven implementation and the possibility of regulatory arbitrage across EU Member States. Equally, whilst this paper has focused on the uncertainties inherent in certain core areas of the Commission's Proposal and the Presidency Compromise Texts, the FMLC is aware that a number of other ambiguities and uncertainties have been identified in submissions by other

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109 It has been suggested that the restriction on the marketing of non-EU funds would not adversely affect EU funds of hedge funds, since they would continue to be able to invest in non-EU funds where their AIFM are not established in the EU. However, since the definition of "marketing" encompasses offers made both on a solicited and unsolicited basis, it is difficult to see how such funds of hedge funds could in practice invest in such non-EU funds given that the AIFM in question would not be able to market the funds to them due to the difficulties which are prevalent in trying to satisfy the Equivalence Requirement and the Market Access Requirement. Further uncertainty has been introduced by the suggested amendments to the definition of "marketing" in Article 3 of the Final Swedish Presidency Text. It is thereby proposed that "marketing" is limited to direct or indirect offerings or placements of shares or units in AIFs which are undertaken "at the initiative of the AIFM or on behalf of the AIFM" and offered to investors domiciled in the Community. It is intended that the Commission shall adopt implementing measures clarifying the circumstances under which marketing shall be deemed to be "at the initiative of the AIFM or on behalf of the AIFM". Such clarification is very much needed in this regard.

parties. The FMLC considers that every effort to resolve these issues of legal uncertainty should be made during the co-decision process.

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