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ALTERNATIVE INVESTMENT LAW

REPORT

Investment Advisers

The New E.U. Directive On Alternative Investment Fund Managers

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Introduction

On November 11, 2010, the European Parliament (the ''Parliament'') voted to adopt the E.U. Directive on Alternative Investment Fund Managers (the ''Directive'').[1] The Directive has been the subject of intense industry and media scrutiny since the original draft was published by the European Commission (the ''Commission'') on April 30, 2009 (the ''Original Draft'')[2] (see analysis at 16 WORLD SEC. L. REP. (BNA) at 28 (June 2009)).

The Directive will affect a significant cross-section of alternative investment fund managers (''AIFMs'') which manage and/or market alternative investment funds (''AIFs'') within the European Union, including managers of hedge and private equity, venture capital, commodity, infrastructure and real estate funds.

This Insight examines the implications of the finalised directive for AIFMs, both in the European Union (E.U. AIFMs) and outside the European Union (non-E.U. AIFMs).

Timing of Implementation

Now that the European Parliament has voted to adopt the Directive, E.U. finance ministers will formally approve the text on behalf of the Council of the European Union (the ''Council'').

The text will then be translated into the official languages of the E.U. Member States and be published in

[1] The text as adopted by the Parliament is available at page 8 of the document at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+20101111+SIT+DOC+WORD+V0//EN&language=EN.

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[2] The Original Draft is available at http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf.

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the *Official Journal of the European Union*. Publication is anticipated to occur during the first (or possibly second) quarter of 2011. The Directive comes into effect 20 days after publication in the *Official Journal* and Member States are then obliged to transpose the Directive into national law within two years from that day (the date at the end of this two year period being the ''Implementation Date''). Thus, if the Directive is published in the *Official Journal* on February 1, 2011, it will come into effect on February 21, 2011, and must be transposed into Member State law by February 21, 2013 (February 21, 2013, being the Implementation Date in this example).

Issues Discussed

The following are the main issues discussed in this Special Report:

- scope of the Directive;
- marketing of AIFs to professional investors;
- requirement for a ''single AIFM'';
- regulatory capital requirements;
- conduct of business requirements;
- remuneration requirements;
- valuation requirements;
- depositary requirements;
- delegation by the AIFM of its functions;
- disclosure requirements; and
- leverage limits.

Scope of the Directive

The Directive regulates AIFMs; it does not regulate AIFs directly. The Directive is expressly stated to apply to:

- E.U. AIFMs which manage one or more AIFs, regardless of whether the AIFs are E.U. or non-E.U. AIFs; and
- non-E.U. AIFMs which either:
  - manage one or more AIFs which are domiciled in the European Union (*e.g.*, U.S. manager managing an Irish fund); or
  - market one or more AIFs (whether E.U. or non-E.U. AIFs) to investors in the European Union (*e.g.*, U.S. manager marketing a Cayman Islands fund or a Luxembourg fund to E.U. investors).

A minimum threshold applies in relation to the application of the full scope of the Directive; the main provisions of the Directive apply only where the AIFM manages assets of €100 million or more. A higher threshold of €500 million applies to AIFMs that do not utilise leverage and have a five year lock-in period for their investors (this threshold may be useful for small private equity funds).[3]

The nature and type of investment fund is not relevant — it does not matter whether the fund is open-ended or closed-ended, listed or unlisted, or whether the fund is a hedge fund, fund of funds, private equity fund, venture capital fund, real estate fund or commodity fund; all types of collective investment schemes, other than UCITS,[4] are considered to be AIFs and caught by the Directive so long as the relevant threshold (€100 million or €500 million) is reached. The size of the manager is also irrelevant so long as the relevant threshold is reached.

Where the AIF is self-managed (which is the case for certain types of investment funds), the AIF itself would be considered to be the AIFM.

Marketing of AIFs to Professional Investors[5]

Definition of 'Marketing.' The Directive defines ''marketing'' to mean ''any direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares in an AIF it manages to or with investors domiciled in the Union''.

The words ''at the initiative of the AIFM'' mean that reverse enquiries by investors will not be caught under the definition; thus ''passive'' (as opposed to active) marketing by AIFMs would not be considered to be ''marketing'' under the Directive. However, it may not always be easy to evidence the ''passive'' nature of the AIFM, particularly where the AIFM regularly meets existing investors in its AIFs as part of general investor liaison.

The words ''direct or indirect'' and ''or on behalf of the AIFM'' indicate that the AIFM would be considered to be ''marketing'' even if all actual marketing activity was carried out in the European Union solely by a marketing or distribution agent.

Dual Regime for Marketing of AIFs. The Directive establishes a dual regime for the marketing of AIFs in the European Union. Essentially, an AIFM can market AIFs either:

- into individual E.U. Member States under a national private placement regime — under this regime, an individual E.U. Member State may (if it wishes to do so at all) allow non-E.U. AIFMs to market E.U. or non-E.U. AIFs in that Member State. For example, a U.S. manager may be able to market its Cayman Islands fund in Austria if the Austrian regulator expressly allows it; or
- into all E.U. Member States under an EU-wide ''passport'' regime — under this regime, an AIFM can market AIFs throughout the whole of the European Union, with no barriers allowed to be placed at individual Member State level. For example, a U.S. manager with a Cayman Islands fund would be able to market throughout the whole of the European Union under this regime (including into jurisdictions such as France and Italy, which have historically been difficult to market into).

However, the availability, starting dates and possible end dates of these two regimes differ, as follows:

- In the case of an E.U. AIFM marketing an E.U. AIF, the passport regime is available from the Implementation Date.
- In the case of 1) an E.U. AIFM marketing a non-E.U. AIF, or 2) a non-E.U. AIFM marketing any E.U. or non-E.U. AIF:

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[3] Leverage at the level of the private equity fund-owned portfolio companies is not ''leverage'' for these purposes.

[4] ''UCITS'' refers to Undertakings for Collective Investments in Transferable Securities; these are E.U. regulated investment funds which can be marketed freely across the European Union to professional as well as retail investors.

[5] The Directive also gives individual Member States the right to allow the marketing of AIFs to retail investors in their jurisdictions.

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■ the national private placement regime is available from the Implementation Date; but

■ the passport regime becomes available only two years after the Implementation Date, and only if the European Securities and Markets Authority (''ESMA'') (the new pan-E.U. securities regulator) recommends its implementation and the Commission ''activates'' it (which it is expected it will do).

■ In all cases:

■ the national private placement regime may be abolished around five years after the Implementation Date (assuming ESMA recommends such abolition and the Commission acts to abolish it); but

■ the passport regime continues indefinitely.[6]

By way of example, using February 21, 2013, as the Implementation Date:

■ the national private placement regime will start from February 21, 2013, but may be abolished around the middle of 2018;

■ the passport regime for E.U. AIFMs marketing E.U. AIFs will start on February 21, 2013, and continue indefinitely; and

■ the passport regime for E.U. AIFMs marketing non-E.U. AIFs, and for non-E.U. AIFMs marketing E.U. or non-E.U. AIFs, is expected to start around the middle of 2015 and continue indefinitely.

As a practical matter, this means that an E.U. AIFM which markets an E.U. AIF will have an advantage over any E.U. or non-E.U. AIFM which markets a non-E.U. AIF, because that E.U. AIFM will have the benefit of the E.U. passport from the Implementation Date, while other AIFMs will have to wait at least two years after that Implementation Date. As explained below, however, non-E.U. AIFMs may not be in any great hurry to utilise the passport regime because that would require full compliance with the Directive.

We now consider the various permutations of AIFMs marketing AIFs.

E.U. AIFM Marketing E.U. AIF. An E.U. AIFM marketing an E.U. AIF must be authorised under, and comply with all provisions of, the Directive. It can then market its E.U. AIF throughout the whole of the European Union on the basis of the E.U. passport from the Implementation Date. The national private placement regime is not relevant for an E.U. AIFM since the E.U. AIF already has the freedom to market into all Member States under the passport.

E.U. AIFM Marketing Non-E.U. AIF. An E.U. AIFM marketing a non-E.U. AIF can choose to use either the national private placement regime from the Implementation Date, or the E.U. passport regime from two years after the Implementation Date (assuming that the passport becomes available).

Where the E.U. AIFM wishes to use the national private placement regime to market a non-E.U. AIF into a Member State which allows for such marketing:

■ it must comply with all provisions of the Directive other than the ''depositary'' provisions (discussed further below), as well as any additional local requirements in that Member State;

■ cooperation arrangements must be in place between the E.U. AIFM's regulator and the regulator in the non-E.U. AIF's home country; and

■ the non-E.U. AIF's home country must not be listed as a ''non-cooperative country'' by the Financial Action Task Force on anti-money laundering and terrorist financing (the ''FATF'').

Where the E.U. AIFM wishes to use the passport regime to market a non-E.U. AIF throughout the whole of the European Union:

■ it must comply with all provisions of the Directive;

■ cooperation arrangements must be in place between the E.U. AIFM's regulator and the regulator in the non-E.U. AIF's home country;

■ the non-E.U. AIF's home country must not be listed as a ''non-cooperative country'' by the FATF; and

■ the non-E.U. AIF's home country must have a tax transparency agreement with each Member State into which the AIF will be marketed under the passport.

Non-E.U. AIFM Marketing E.U. AIF. A non-E.U. AIFM marketing an E.U. AIF can choose to use either the national private placement regime from the Implementation Date, or the E.U. passport regime from two years after the Implementation Date (assuming that the passport becomes available).

Where the non-E.U. AIFM wishes to use the national private placement regime to market an E.U. AIF into a Member State which allows for such marketing:

■ it must comply with the disclosure and transparency provisions of the Directive (but not the rest of the Directive), as well as any additional local requirements in that Member State;

■ cooperation arrangements must be in place between the regulator in the relevant Member State and the regulator in the non-E.U. AIFM's home country; and

■ the non-E.U. AIFM's home country must not be listed as a ''non-cooperative country'' by the FATF.

Where the non-E.U. AIFM wishes to use the passport regime to market an E.U. AIF throughout the whole of the European Union:

■ it must become authorised under the Directive by seeking authorisation from its ''Member State of reference'' and comply with all provisions of the Directive;

■ cooperation arrangements must be in place between the regulator in the ''Member State of reference'' and the regulator in the non-E.U. AIFM's home country;

■ the non-E.U. AIFM's home country must not be listed as a ''non-cooperative country'' by the FATF; and

■ the non-E.U. AIFM's home country must have a tax transparency agreement with the ''Member State of reference''.

Non-E.U. AIFM Marketing Non-E.U. AIF. A non-E.U. AIFM marketing a non-E.U. AIF can choose to use either the national private placement regime from the Implementation Date, or the E.U. passport regime from two years after the Implementation Date (assuming that the passport becomes available).

Where the non-E.U. AIFM wishes to use the national private placement regime to market a non-E.U. AIF into a Member State which allows for such marketing:

■ it must comply with the disclosure and transparency provisions of the Directive (but not the rest of the Directive), as well as any additional local requirements in that Member State;

■ cooperation arrangements must be in place between the regulator in the relevant Member State and

[6] However, if for some reason the passport is never introduced in 2015, then it would be difficult to see how the national private placement regime could be abolished.

the regulator in each of the non-E.U. AIFM's home country and the non-E.U. AIF's home country; and

- each of the non-E.U. AIFM's home country and the non-E.U. AIF's home country must not be listed as a "non-cooperative country" by the FATF.

Where the non-E.U. AIFM wishes to use the passport regime to market a non-E.U. AIF throughout the whole of the European Union:

- the non-E.U. AIFM must become authorised under the Directive by seeking authorisation from its "Member State of reference" and comply with all provisions of the Directive;
- cooperation arrangements must be in place between the regulator in the "Member State of reference" and the regulator in the non-E.U. AIFM's home country;
- cooperation arrangements must be in place between the regulator in the "Member State of reference" and the regulator in the non-E.U. AIF's home country;
- each of the non-E.U. AIFM's home country and the non-E.U. AIF's home country must not be listed as a "non-cooperative country" by the FATF; and
- the non-E.U. AIFM's home country must have a tax transparency agreement with the "Member State of reference".
- the non-E.U. AIF's home country must have a tax transparency agreement with each Member State into which the AIF will be marketed under the passport.

Some Observations on the Requirements Relating to Non-E.U. AIFs

As noted above, non-E.U. AIF countries such as the Cayman Islands and Jersey will need to enter into cooperation agreements and tax agreements with various E.U. Member States, and also ensure that they are not listed as non-cooperative countries by the FATF. One would expect that these conditions will be met without much, if any, difficulty by the more established offshore fund jurisdictions. Indeed, there have been public declarations by regulators or governments in some of those jurisdictions expressing their commitment to meeting whatever conditions might be imposed by the Directive on non-E.U. AIF countries. The Cayman Islands and other jurisdictions already have a number of tax transparency agreements with some E.U. Member States. Also, there are at present no countries at all listed by the FATF as non-cooperative countries, so that condition is easily met. In relation to cooperation arrangements, no form of cooperation agreement is available yet, but one expects the major non-E.U. AIF countries to work quickly to enter into those agreements with the relevant E.U. Member States.

Some Observations on the Requirements Relating to Non-E.U. AIFMs

As can be seen above, as far as the non-E.U. AIFM is concerned, there is no real difference between marketing an E.U. AIF or marketing a non-E.U. AIF; the only difference is that in the case of marketing a non-E.U. AIF, the non-E.U. AIF's jurisdiction must also satisfy the relevant conditions. So from a non-E.U. AIFM's perspective, it would not appear that there would be any real benefit to redomiciling their non-E.U. AIFs to become E.U. AIFs.

It is worth considering a few issues which arise in relation to a non-E.U. AIFM which uses the passport regime to market AIFs (whether E.U. or non-E.U. AIFs).

As a starting point, the use of the passport regime would require that the non-E.U. AIFM become authorised (*i.e.*, registered) with the regulator in that non-E.U. AIFM's "Member State of reference" ("MSR"). The MSR is likely to be the E.U. Member State where the AIFM intends to "develop effective marketing" for most of its AIFs. There is no need for the non-E.U. AIFM to establish a physical presence (*e.g.*, a branch) in its MSR or anywhere else in the European Union. However, the non-E.U. AIFM must have a "legal representative" in the MSR.

The "legal representative" of the non-E.U. AIFM is to be the official contact point for the MSR regulator, and will be responsible for "the compliance function relating to the management and marketing activities performed by the AIFM under the Directive together with the AIFM".

The form of the legal representative is not mandated, so it could either be a branch of the non-E.U. AIFM (*i.e.*, sharing the same legal identity as the non-E.U. AIFM) or a separate legal entity altogether (*e.g.*, a subsidiary or unaffiliated third party).

The Directive does not require that the legal representative be an affiliate of the non-E.U. AIFM. This is sensible, because a non-E.U. AIFM's MSR can change (for example, if it changes its marketing focus from one Member State to another). It may be possible therefore to simply appoint a service provider in the MSR to carry on the legal representative function. If the MSR does move to another Member State, then the non-E.U. AIFM will have to appoint a new legal representative in that new MSR.

It is implicit in the legal representative provisions of the Directive that the legal representative is the entity that would get enforced against by an E.U. regulator should the non-E.U. AIFM fail to comply with the Directive. However, it is not clear how that would work in practice, and what sort of deterrent effect it would have on non-E.U. AIFMs in terms of non-compliance with the Directive.

Finally, the Directive recognises that the non-E.U. AIFM may already be subject to some other regulatory regime in its home jurisdiction. The Directive thus provides that the non-E.U. AIFM does not have to comply with a provision in the Directive if it can show that that provision is incompatible with a rule or law to which it is subject in its home jurisdiction (a "home rule") and it is "impossible" to comply with both at the same time. The home rule must have the "same regulatory purpose" and offer "the same level of protection" to the AIF's investors as the relevant provision in the Directive. From a practical standpoint, it is not clear how many home rules will have the "same purpose" and offer the "same protection" as a provision in the Directive and yet still be incompatible with that provision.

We now turn to the general provisions of the Directive which, as stated earlier, apply to E.U. AIFMs generally and to non-E.U. AIFMs wishing to use the passport regime; certain provisions apply or do not apply where the private placement regime is used. In the sections below, a reference to an AIFM's "home Member State" would be, for a non-E.U. AIFM, a reference to the MSR for that non-E.U. AIFM.

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Requirement for a 'Single AIFM'

The Directive requires that each AIF can have only a single AIFM. That is, if the services of more than one AIFM are desired, one AIFM must be the "main" AIFM for the purposes of the Directive and take primary responsibility in relation to that AIF, while any other AIFM would have to be a delegate of that principal AIFM.

Some non-E.U. fund managers have sub-advisory (more accurately, sub-management) subsidiaries in the European Union. For example, some U.S. hedge fund managers have small U.K. subsidiaries, which are delegated some investment management authority over the relevant fund. Because any entity which engages in "portfolio management" or "risk management" falls within the definition of "managing AIF", it would appear that an E.U. sub-management subsidiary would have to become authorised under the Directive and in turn become subject to this "single AIFM" rule. In theory this means that the E.U. subsidiary (which may be very small compared to its parent manager) might have to be designated as the "single AIFM", which would result in the odd situation where the non-E.U. parent would have to be the delegate of its subsidiary. There is a lack of clarity on this issue, and it is hoped that the Commission or ESMA will clarify this before the Implementation Date.

Regulatory Capital Requirements

An internally managed (*i.e.*, self managed) AIF must have initial capital of at least €300,000. AIFMs appointed as external managers must maintain initial capital of the higher of 1) one-fourth of their annual expenditure (salaries, rent, utilities, *etc.*); and 2) €125,000. In addition, where the value of the AIFs managed by the AIFM exceeds €250 million, the AIFM will be obliged to have an additional amount of capital equal to 0.02 percent of the amount by which the value of the AIF's assets exceeds €250 million, subject to a ceiling of €10 million. Fifty percent of the amount of such additional capital may be provided by way of a bank guarantee.

Conduct of Business Requirements

The conduct of business requirements which AIFMs will be subject to under the Directive include the following:

- Fair treatment of AIF investors — This includes a requirement that no investor may obtain preferential treatment unless it is disclosed in the AIF documentation. This means that side letter arrangements would have to be disclosed (although the identities of the individual investors do not have to be disclosed).
- Conflicts of interest — There is a requirement to identify conflicts of interest as between the AIFM and the AIF investors, as well as between AIFs, and to manage such conflicts.
- Risk management — AIFMs will have to ensure that the functions of risk management and portfolio management are separate. Member State regulators will be responsible for assessing, on a proportionate basis, whether an AIFM has sufficient safeguards in place to ensure that no conflict of interest arises in respect of the performance of risk and portfolio management.
- Liquidity management — AIFMs will have to conduct stress tests regularly and monitor the liquidity risk of open-ended AIFs accordingly. The investment strategy, liquidity profile and redemption policy of each AIF managed by the AIFM must be consistent with each other.
- Investments in securitisations — AIFMs will not be able to invest AIF funds in securitisation positions unless the originator of the securitisation retains at least a 5 percent net economic interest in the securitisation. This is in line with certain amendments (known as "CRD II") to the E.U. securitisation rules contained in the E.U. Capital Requirements Directive, which contains the regulatory capital rules for E.U. credit institutions (*i.e.*, banks). Certain qualitative requirements may also have to be met by the AIFM; the Directive does not specify what those are (the Commission will publish the requirements), but they may include due diligence and ongoing monitoring requirements on the underlying assets of the securitisations.

Remuneration Requirements

The Directive introduces requirements for AIFMs to have remuneration policies and practices that are consistent with and promote sound and effective risk management and do not encourage excessive risk taking. The remuneration provisions in the Directive are based on those contained in amendments (known as "CRD III") to the E.U. Capital Requirements Directive.

The remuneration requirements apply to *all* AIFMs authorised under the Directive, regardless of the type of AIFM (or type of AIF managed). Amongst other things, the Directive prohibits guaranteed multi-year bonuses, requires that at least 50 percent of any bonus payments be in the form of units or shares of the AIF, and also requires that 40 percent to 60 percent of bonus payments should be deferred "over a period which is appropriate in view of the life cycle and redemption policy of the AIF concerned" (at least three to five years). The remuneration provisions are expected to apply not only to senior managers and risk takers, but also "control staff", which could include certain staff such as internal legal and compliance staff.

Valuation Requirements

The Directive does not require that an external valuation agent be appointed in respect of an AIF; the AIFM can carry on the valuation function itself. However, where an AIFM decides to carry out the valuation function itself, it must ensure that the process is functionally independent from the portfolio management and remuneration policy of the AIF and that measures are put in place to mitigate conflicts of interest. E.U. Member State regulators will have the power to require the AIFM to subject its valuation procedures and/or valuations to verification by an external valuation agent or auditor.

Depositary Requirements

An AIFM must appoint a single depositary in respect of each AIF it manages. The depositary can either be an E.U. credit institution (*i.e.*, a regulated bank) or an E.U. investment firm (*i.e.*, a securities firm). Also, in recog-

nition of the fact that private equity funds do not rely on third party custodians, the Directive provides that for AIFs which do not have assets which are traded (broadly speaking), the depositary may be an ''entity'' which carries out depositary functions as part of its professional or business activities.

For a non-E.U. AIF, the depositary must be established in either: 1) the non-E.U. AIF's home country (*e.g.*, Cayman Islands); 2) the home Member State of the AIFM (where the AIFM is in the European Union); or 3) the MSR of the AIFM (where the AIFM is a non-E.U. AIFM using the passport regime). As a consequence, a U.S. manager cannot use a U.S. depositary under the passport regime; one possible option is to appoint a depositary in the MSR but then continue to use multiple prime brokers in the United States and elsewhere. As noted above, however, a non-E.U. AIFM's MSR can change; if it does so, that would cause disruption, as a new depositary would have to be appointed.

The depositary serves two broad functions: 1) it acts as a custodian for the AIF's assets; and 2) it is responsible for monitoring the AIF's cash flows (and matters such as redemptions of units of the AIF). It is worth noting that a depositary will be able to delegate responsibility only for custodial activities to a third party, but not its monitoring responsibilities.

As a general matter, the depositary remains liable for the failures of its delegates, but the Directive provides that a depositary can contract out of its liability to the AIFM/AIF for loss of financial instruments where it can show, amongst other things, that the delegate: 1) has been chosen by the primary depositary with ''all due skill, care and diligence''; 2) meets certain standards (*e.g.*, it is regulated, it segregates assets, it is subject to prudential supervision, *etc.*); and 3) has entered into a written contract which explicitly transfers liability to the delegate.

The Directive recognises the concept of a ''prime broker'', but an AIF's prime broker cannot also be the depositary unless its prime brokerage and its depositary functions are ''functionally and hierarchically'' separated. It is not clear at present how many existing prime brokers wish to take on the depositary function, given the fairly high standards of liability placed on depositaries.

It is worth noting that the depositary cannot be the external valuation agent of the AIF, unless the valuation functions are separated from the depositary functions.

Delegation by the AIFM of its Functions

An AIFM must notify its regulator if it chooses to delegate any of its functions. It may delegate its portfolio and/or risk management functions only to regulated entities; where this condition cannot be satisfied, delegation is subject to prior authorisation of the AIFM's regulator. Where the delegate is in a non-E.U. country, cooperation between the regulators in the AIFM's home Member State and the non-E.U. country must be assured.

An AIFM which elects to delegate to a third party will still remain liable to the AIF and its investors to the same extent it would have been liable had no such delegation been made.

Note to Readers

The editors of BNA's *Alternative Investment Law Report* invite the submission for publication of articles of interest to practitioners.

Prospective authors should contact the Managing Editor, BNA's *Alternative Investment Law Report*, 1801 S. Bell St. Arlington, Va. 22202-4501; telephone (703) 341-3889; or e-mail to sjenkins@bna.com.

Disclosure Requirements

The Directive imposes fairly comprehensive disclosure requirements. Amongst other things, an AIFM will have to comply with the following:

■ Annual report — To the extent that an AIFM's publicly available annual financial report does not meet the disclosure requirements set out in the Directive, it must prepare an audited annual report for each AIF it manages. The report must be made available to investors and the relevant regulator(s). The annual report must include details of remuneration.

■ Disclosure to investors — AIF investors must be provided with detailed information about the AIF, including its strategy, assets that may be invested in, valuation procedures, and descriptions of preferential treatment (*e.g.*, through side letters). Thus, it may not be possible to have ''black box'' hedge funds. On an ongoing basis, an AIFM must disclose to the AIF investors the percentage of the AIF's assets which are illiquid and thus subject to special arrangements (*e.g.*, side pockets), any changes in managing the liquidity of the AIF and the current risk profile of the AIF. The AIFM must also disclose to investors the amount of leverage employed (if any) by the relevant AIF on a regular basis.

■ Reporting to the regulator — An AIFM must report to its home Member State regulator(s) all matters relating to the AIF, including those disclosed to AIF investors. In addition, where an AIFM manages an AIF which employs leverage ''on a substantial basis'', the AIFM must provide to its regulator specific details relating to the leverage position of the AIF it manages, including identifying the five largest sources of borrowed cash or securities for each AIF. The Directive is silent on when leverage will be considered to be ''on a substantial basis'', instead leaving this to the Commission to clarify at a later stage.

■ Notification of controlling influence in unlisted companies — This requirement is of particular relevance to private equity managers. Where an AIF acquires 50 percent or more of the voting rights of a non-listed company (not including small and medium enterprises (SMEs)), the AIFM would have to provide information of its holding: 1) to the company; 2) to all other shareholders of the company; and 3) to its home Member State regulator. The AIFM will also be obliged to make disclosures regarding, amongst other things, the future development of the non-listed company either in such non-listed company's annual report or, alternatively in the annual report of the AIF.

Leverage Limits

The Directive requires that an AIFM set and comply with leverage limits for each AIF managed by it. The

AIFM must be able to demonstrate that the leverage limits it sets are reasonable.

One contentious issue that arose from the Original Draft was the unfettered ability of the Commission to set limits to the level of leverage AIFMs could employ. The concern was that the Commission was not in a good position to impose EU-wide limits when the industry (particularly the hedge fund industry) was concentrated in a few Member States; more importantly, it was unclear what criteria the Commission would apply in imposing such limits.

The approach has been softened somewhat so that Member State regulators (as opposed to the Commission) will be able to impose (on a temporary basis) limits on leverage levels ''when it is deemed necessary in order to ensure the stability and integrity of the financial system''.

ESMA will be responsible for ensuring that Member State regulators take a consistent approach when imposing restrictions on leverage. Given that 80 percent of the E.U. hedge fund industry is located in the United Kingdom, the U.K. Financial Services Authority's view on leverage will be important.

Conclusion

The Directive has come through a long process of negotiation, particularly between the Parliament and the Council. It may now have been adopted, but between its adoption and the Implementation Date some time in early 2013, much work will have to be carried out as part of the ''Level 2'' process (the Directive being ''Level 1''). Amongst other things, the Commission will need to publish ''delegated acts'' on the interpretation of certain provisions in the Directive; ESMA will also be providing guidance on various matters.

The investment funds industry will need to monitor closely the Commission's consultation papers and views during the Level 2 process in order to ensure that the provisions of the Directive are not interpreted in a way that is damaging to the industry.