

AIFMD: Challenges and Opportunities

- Dr Charles Cassar

1. Introduction

Over the last few years Malta has worked hard to position itself as a domicile for hedge funds (in the sense of collective investment schemes marketed exclusively to investors meeting certain minimum sophistication criteria) and has achieved considerable success in this regard, such that one may well speak of the country as an established jurisdiction in the sector. Between 2004 and June 2011 a total of six hundred and sixty one new funds were licensed, and the net asset value of all Malta domiciled funds was of EUR 7.8 billion at the end of June 2011. Much of this growth is the result of the set up in Malta of a large number of Professional Investor Funds ('PIFs'), the local hedge fund product; four hundred and seven PIFs were domiciled in Malta at the end of June 2011.¹

The hedge funds industry is thus becoming an important contributor to the Maltese economy. The recent voting through of the Directive on Alternative Investment Fund Managers ('AIFMD' or 'the Directive'),² an EU Directive which

establishes a regulatory framework for 'alternative investment fund managers',³ is therefore a matter which merits attention.⁴

It is safe to say that the Directive did not win any popularity contests when it was first proposed, and was greeted with alarm and suspicion in many quarters. In this paper I will therefore discuss the concerns raised with respect to the Directive and whether we should expect concerns to materialize in ways which are harmful to the local hedge funds industry. In order to do so, I will first discuss the evolution of the directive and the political and economic forces which influenced this evolution; I believe it is difficult to make sense of the directive (and consequently its likely impact on the local industry) without an understanding of the context in which it was conceived and negotiated. I will then provide a summary of the directive's principal provisions. Finally, I will comment on how these provisions are likely to impact the local hedge funds industry. I conclude that the Directive is unlikely to cause significant harm to the local hedge funds industry, and that while it does raise some challenges, the Directive also gives rise to interesting opportunities.

¹ Figures derived from 'Analysis of Collective Investment Schemes licensed by the Malta Financial Services Authority, Quarters 1 and 2 – 2011', MFSA, September 2011.

² Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on

Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

³ A broadly defined category which includes hedge funds

⁴ Article 2

2. The Political Landscape

2.1. An unpopular law

The voting through of the AIFMD was accompanied by a statement⁵ of the European Commission containing the following lines:

The European Parliament has just voted through, with a very large majority, the Directive on Alternative Investment Fund Managers (AIFM). These were difficult negotiations [emphasis added] but the final outcome will result in a sounder, more stable financial system.

This telling statement acknowledges the controversial nature of the Directive. Indeed, since it was first proposed on the 29th of April 2009, the Directive has been very widely criticized: the Alternative Investment Management Association (AIMA) condemned it as containing ‘many ill-considered provisions’;⁷ Lord Myners, the financial services secretary to the HM Treasury, said it needed ‘major surgery’ and

⁵ European Commission statement at the occasion of the European Parliament vote on the directive on hedge funds and private equity, 11/11/2010, MEMO/10/573

⁶ IP/09/669: Commission proposes EU framework for managers of alternative investment funds (29/04/2009)

⁷ Florence Lombard (AIMA executive director), ‘EC Directive Does Not Deliver Proportionate Response’ (29/04/2009)

described it as ‘flawed’;⁸ the director of euro skeptic think tank Open Europe⁹ commented that ‘there has rarely been a law with so many losers and so few winners’.¹⁰

The April 2009 proposal was controversial for many reasons. Many commentators noted that the initial draft had apparently been ‘hastily prepared’.¹¹ This resulted in an initial text which was occasionally unclear and seemed to indicate insufficient familiarity with the industry, by, for example, not including provisions addressing the self-managed fund structures¹²

⁸ Miles Costello and Patrick Hosking, ‘City Minister Calls for ‘surgery’ on EU hedge fund curbs’, The Sunday Times, (08/07/2009)

⁹ <http://www.openeurope.org.uk/>

¹⁰ Mats Persson, ‘The AIFM Directive: what are they thinking?’, (17/05/2010) <http://blogs.euobserver.com/> accessed 20/11/2010

¹¹ Florence Lombard, op. cit.,; ‘Hasty regulation is not the answer’ Gerben Evans, APG Asset Management at the ECON Public Hearing on the AIFM Directive (10/10/2009); KPMG, ‘Alternative Investment Fund Managers Directive (AIFM), kpmg.co.uk (accessed 21/11/2010)

¹² Compare the initial draft of the directive proposed on the 30th of November 2009, to the 27th October 2010 text. While the former contains makes no mention of self-managed fund structures, the latter recognizes in Recital 16 that ‘Depending on their legal form, AIF could be either externally or internally managed’, as well as various provisions which take into account the specific characteristics of such ‘internally managed’ funds, *vide* Articles 6, 9 et al.

which are permitted in Malta.¹³ Others took issue with the directive's explanatory memorandum's statement¹⁴ that 'the risks associated with their [AIFM] activities have manifested themselves throughout the AIFM industry over recent months and may in some cases have contributed to market turbulence'.¹⁵

Perhaps most damagingly, the AIFMD was accused of being protectionist. The accusation of protectionism is one which was echoed by various industry stakeholders: AIMA commented¹⁶ that the third countries section of

the directive 'could have unfortunate protectionist consequences'¹⁷; mayor of London Boris Johnson maintained that the Directive should take on a less protectionist shape¹⁸; Eversheds partner Ronald Patterson noted that the proposal looks protectionist from the point of view of London.¹⁹

Having briefly touched upon the various criticisms that were directed at the AIFMD, I will proceed to focus on the political and economic milieu in which the Directive evolved.

2.2. The Financial Crisis

Run up to the April 2009 announcement

Many commentators have framed the discussion regarding the origins of the AIFMD within the context of the widespread concern over the financial crisis; in particular, many have argued that the Directive was a 'knee-jerk' reaction to the crisis.²⁰ This may not

¹³ Investment Services Rules for Professional Investor Funds, Part B, Appendix I

¹⁴ Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers amending Directives 20/04/39EC and 2009/.../EC, 1.1 Context, grounds for, objectives of the proposal.

¹⁵ The charge that alternative investment funds have significantly contributed to the financial crisis has been rejected by the hedge funds industry. See Reuters, 'Hedge funds say role in crisis was marginal: AIMA'. The view also enjoys support from various commentators such as former SEC chairman Arthur Levitt: 'I am not particularly concerned about hedge funds. I don't think they played a central role in the financial crisis', Securities Technology Monitor, interview by Carol E. Curtis, (08/02/2010). See also Roubini Global Economics, 'The Role of Hedge Funds in Financial Crisis' (20/10/2010)

¹⁶ The comment was made in the context of the Spanish compromise text

¹⁷ <http://blogs.ft.com/ftfmblog>, 'AIFM Directive: creeping protectionism?'

¹⁸ Euractiv.com, 'Mayor of London lobbies Brussels against 'protectionist' regulation' (03/09/2010)

¹⁹ As quoted in Investments & Pensions Europe, 'French U-Turn brings 'passport' for non-EU AIFMs closer to reality' (13/10/2010).

²⁰ "Ultimately, the AIFM directive was a knee-jerk reaction to the economic crisis, and was put together in haste. There's little doubt it was politically motivated, with no proper consultation, certainly not in the initial stages at least. The number of changes proposed – there have been more than 1,700 amendments suggested – showed it wasn't properly thought

be entirely accurate since unease about the activities of hedge funds had been voiced in some quarters prior to the crisis. In May 2005, then German chancellor Gerhard Schröder had called for hedge funds to be subject to tougher regulation following the ousting of the Deutsch Börse's management as a result of pressure applied by an activist hedge fund shareholder, 'The Children's Investment Fund', a British hedge fund. The same debacle had also led the then chairman of the Social Democratic Party of Germany, Franz Müntefering to describe hedge funds as 'locusts'.²¹ In Denmark, the takeover of a Tele-Danmark Communications by a group of private equity firms in December 2005,²² caused much consternation

through in the first place." Anna Holm Rannaleet, chairman, IK Investment Partners advisory board, 'Rising tide of regulation risks drowning industry', Oliver Smiddy, Financial News, 24th January 2011

"This is a significant lost opportunity and is a political knee jerk reaction to a crisis that doesn't exist.", IMS Group 'EU moves the regulatory goal posts for alternative managers: Prepare for the UK versus Europe', 29th April 2010

'The draft Directive has already invited a lot of criticism from industry experts and AIFMs for what they see as a knee-jerk reaction to a financial crisis not precipitated by their activities.' Damien Barnaville, LK Shields, 'Knee-jerk Reaction or Reasoned Response?', 2009

²¹ Peter Gumbel, 'The Day of the Locusts', Time Magazine World, 15th May 2010

²² "The Lawyer" Funds Summit, speech by Richard Saunders, Chief Executive,

and eventually led to former Danish Prime Minister Poul Nyrup Rasmussen becoming an outspoken critic of the hedge funds and private equity industries.²³

Nevertheless it is clear that the financial crisis played an important role in shaping the Directive and pushing it to the top of the political agenda. It is useful to look at some of the events preceding the April 2009 announcement in order to appreciate the context in which it was made²⁴:

- 11th July 2007 – hundreds of subprime backed securities downgraded by Standard and Poor's
- 31st July 2007 – Bear Sterns liquidates two hedge funds that invested in various types of mortgage-backed securities
- November 2007 – Interbank funding markets dry up
- February 2008 – Northern Rock taken into state ownership by the Treasury of the United Kingdom
- 7th September 2008 – Fannie Mae and Freddie Mac placed in government conservatorship
- 15th September 2008 – Lehman Brothers Holdings Incorporated files for

Investment Management Association, 25th November 2010

²³ Poul Nyrup Rasmussen, 'Taming the Private Equity Locusts', Project Syndicate, 4th April 2008

²⁴ Federal Reserve Bank of St. Louis, The Financial Crisis: A timeline of events and policy actions, <http://timeline.stlouisfed.org/index.cfm?p=home>

Chapter 11 bankruptcy protection

- 11th December 2008 – Bernard Madoff arrested on charges of running multi-billion Ponzi scheme.²⁵
- 26th March 2009 – US Treasury department outlines a framework work regulatory reform, introducing registration requirements for hedge funds

The April 2009 announcement was therefore made at a time when the financial storm still raged unabated. It is plausible to conclude that the gestation period of the Directive was accelerated in response to the unfolding events. Many commentators argued that the Directive was ‘hastily drafted’²⁶. There does seem to be some merit

²⁵ The New York Times, ‘A Timeline of the Madoff Fraud’, ‘The Ponzi scheme orchestrated by Bernard L. Madoff was the largest fraud by anyone in American history, involving \$65 billion and damaging the finances of thousands’, <http://www.nytimes.com/interactive/2009/06/29/business/madoff-timeline.html>

²⁶ Joy Dunbar quoting Brian Scouler, Dunedin Enterprises, ‘AIFM continues to threaten private equity industry’, 22nd April 2010, www.ftadviser.com. See also, Julian Korek, HFM Week, 28th April 2010: ‘With a rising head of steam, a piece of legislation was hastily drafted over two months by the European Commission, at the request of Poul Nyrup Rasmussen, a Danish MEP and president of the Party of European Socialists. It was published on 30 April 2009 and entitled the Alternative Investment Fund Managers (AIFM) Directive’

to this critique; by February 2010, nearly 1,700 amendments to the AIFMD were tabled in the European Parliament.²⁷

AIF and the Financial Crisis

There being reasonable grounds to believe that the financial crisis had a role in focusing political and regulatory effort on the alternative investment funds industry, it is logical to ask what motivated this shift. The Explanatory Memorandum accompanying the April 2009 proposal noted that²⁸:

While AIFM were not the cause of the crisis, recent events have placed severe stress on the sector. The risks associated with their activities have manifested themselves throughout the AIFM industry over recent months and may in some cases have contributed to market turbulence.

The Explanatory Memorandum argues that the financial crisis highlighted the range of risks to which AIF are exposed and concludes that these risks ‘present a threat to creditors, trading partners and to the stability and integrity of European financial

²⁷ Joanne Harris, ‘AIFM amendments set for European parliament debate’, Hedge Funds Review, 22nd February 2010

²⁸ Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC, COM (2009) 207, Explanatory Memorandum

markets'. The Explanatory Memorandum also notes that 'the individual and collective activities of large AIFM, particularly those employing high levels of leverage, amplify market movements and have contributed to the ongoing instability of financial markets across the European Union'.

The financial crisis seems to have crystallized in the mind of the Commission the idea that AIF are magnifiers of systemic risk necessitating 'a comprehensive legislative instrument establishing regulatory and supervisory standards for hedge funds, private equity and other systemically important market players'.

This analysis is by no means universally accepted. Commenting on the Commission's Impact Assessment,²⁹ a report commissioned by the European Parliament's Economic and Monetary Affairs Committee argued that the Commission's analysis of the policy problem was 'vague, sweeping, and inadequate as a basis for justifying regulation', 'lacking any proper economic analytical structure' and bundling together various 'only vaguely-related financial entities'.³⁰

Many commentators have echoed these views. Strömqvist³¹ succinctly states that 'the hedge funds have been affected more by

the present financial crisis than they have affected it'. Similar views were voiced by Shadab³², Lord Turner and by Jacques de Larosière.³³

Catalyst or Smokescreen?

Given the widespread disagreement with the Commission's assessment of the role of hedge funds it is unsurprising to note that many have questioned whether the Directive was genuinely motivated by a desire to mitigate systemic risk. Investment Management Association chairman Richard Saunders spoke of the directive having 'blatantly protectionist' motivations.³⁴ An article in *The Economist* suggested that some European politicians may be exacting revenge on 'speculators' who were thought to have picked on Greece³⁵ and other indebted euro-zone countries.³⁶ Then leader

³² Houman B. Shadab, 'Hedge funds and the financial Crisis', *Mercatus on Policy*, January 2009

³³ As reported in AIMA press release: 'AIMA Welcomes de Larosière, Turner, Myners, Sassoon Comments on Draft Directive'.

³⁴ "The Lawyer" Funds Summit, speech by Richard Saunders, Chief Executive, Investment Management Association, 25th November 2010

³⁵ 'Some European politicians also suspect hedge funds of contributing to severe difficulties in Greece by staking money on whether the country will need to be bailed out to pay its debts', 'Europe and US Quarrel Over Hedge Funds', *NY Times, Dealbook*, 11th March 2010

³⁶ 'Another European mess: plans to regulate equity and hedge funds take

²⁹ Commission staff working document, Impact Assessment, COM (2009) 207, 30th April 2009

³⁰ Europe Economics, 'Analysis of the Commission's Impact Assessment of the Proposed Alternative Investment Manager's Directive'

³¹ Maria Strömqvist, 'Hedge Funds and the Financial Crisis of 2008', *Sveriges Riksbank, Economic Commentaries*, 2009

of the Conservative opposition David Cameron expressed the concern that the crisis was being used as an excuse in order to launch a 'massive land grab' against the UK's financial sector.³⁷ A financial times article encapsulated the concern as follows³⁸:

While the process of regulation is ostensibly all about markets, there is widespread suspicion in London that much of the post-crisis rule-making emanating from the European Union has a political element to it.

Although few firms are rash enough to state it publicly, the perception is that changes under the auspices of the Alternative Investment Fund Managers directive, Mifid II and Basel III are, at least in part, designed to unseat London as the European capital of finance.

3. The Hedge Funds Industry

3.1. The European Perspective

In order to appreciate the nature of these concerns they must be considered within the context of the composition of the European funds industry.

A significant majority of hedge fund managers within the European Union are located in London, the second largest hedge fund management centre in the world after New York. In January 2006,

two steps forward', The Economist, 18th May 2010

³⁷ David Cameron, quoted by Dow Jones Newswires, 8th December 2009

³⁸ Phil Davis, 'London feels the force of regulation', 15th May 2011

78.5%¹⁵ (\$256 billion) of European hedge fund investments were managed out of the United Kingdom. It is estimated that around 20% of global hedge fund assets are managed by United Kingdom hedge fund management groups.³⁹ It should be noted that it is *management* industry that is highly concentrated in London. In Europe, the fund vehicles are clustered in other jurisdictions, such as Ireland and Luxembourg.⁴⁰ Malta is one of a number of secondary jurisdictions that compete for funds business, although it is fast outgrowing its 'secondary' label.⁴¹

Most hedge funds however are domiciled in offshore jurisdictions which do not impose taxation on the vehicle, thus making the investment more efficient from a tax perspective for the end-investor. At the end of 2004, 55% of the total number of global hedge funds - managing 64% of total hedge fund assets - were registered offshore versus 34% in the US; and 9% in the European Union. The most popular offshore location is the Cayman Islands (60% of European hedge fund assets) followed by the British Virgin Islands (15%) and Bermuda (15%).⁴²

³⁹ Report of the Alternative Investment Expert Group to the European Commission: Managing, Serving and Marketing Hedge Funds in Europe, July 2006

⁴⁰ Commission staff working document, Impact Assessment, COM (2009) 207, 30th April 2009

⁴¹ Malta Hedge Fund Services, Hedgeweek Special Report, 2010

⁴² Report of the Alternative Investment Expert Group to the European Commission: Managing, Serving and

3.2. The US Perspective

The US is considered to be the cradle of the hedge fund industry⁴³ as well as its biggest and most important centre.⁴⁴ New York manages by far the most hedge fund assets compared with other cities in the world, with London a distant runner up.⁴⁵ In 2010, 68% of the global hedge fund assets were managed from the US, with 41 % of assets being managed from New York. Large numbers of hedge funds are domiciled in Delaware.⁴⁶ Approximately half of the institutional investor pool originates from the United States.⁴⁷ It is therefore safe to say that the US has one of the most sophisticated and mature hedge fund industries in the world.

Europe is important for the US hedge funds industry. 29% of all European hedge fund investors on

the Preqin database state US-based hedge funds as a preference. European investors are attracted to US hedge funds because of the broad selection of funds and the large number of fund managers with proven track records and account for a significant part of the moneys invested with US managers. This makes Europe a vital source of capital for US fund managers.⁴⁸

It is therefore unsurprising to note that the US did not approve of the allegedly protectionist April 2009 announcement. US Treasury Secretary Tim Geithner said the following in a letter to EU Internal Markets Commissioner Michel Barnier⁴⁹:

Marketing Hedge Funds in Europe, July 2006

⁴³ The term 'hedge fund' was first coined by Carol Loomis in an article appearing in Fortune describing the extraordinary success of a fund managed by Alfred W. Jones, born in Australia to American parents and raised in America. See: 'A brief history of the hedge fund', www.investopedia.com

⁴⁴ Simon Gray, 'Regulation drive underlines changing face of US hedge fund industry', Hedgweek, 30th June 2011

⁴⁵ Tim Human, 'New York dominates hedge fund industry', Inside Investor Relations, 27th April 2011

⁴⁶ Ron S. Geffner, 'Delaware – the hedge fund jurisdiction of choice in the US', Complinet, 11th February 2008

⁴⁷ Hedge Funds, The City UK, May 2011

⁴⁸ 'European investors keen to invest in US-based hedge fund managers', Preqin, 15th February 2010.

<http://www.preqin.com/blog/101/2120/european-investors-us-based-hfs>

⁴⁹ Tim Geithner, Letter to Michel Barnier, 1st March 2010

One issue, which the US and EU have discussed is the regulation of the alternative investment fund management industry. In this area, and others, I believe we agree that it is essential to fulfil our G-20 commitment to avoid discrimination and maintain a level playing field. In this context, we are concerned with various proposals that would discriminate against US firms and deny them access to the EU market place that they currently have. We strongly hope that the rules that you put in place will ensure that non-EU fund managers and global custodian banks have the same access as their European counterparts. You will see that our approach in the US maintains full access for EU fund managers and custodians to our markets.⁵⁰

3.3. Conclusion

The picture that emerges from the above is one in which a technical discussion, ‘how best to regulate a large and diverse industry’ is taken over, shaped and moulded by various parties with diverging political and economic agendas: continental jurisdictions move to regulate what they perceive as financial rogues against the backdrop of popular clamour for scapegoats and the background rumble of the financial storm, London resisting changes that may

⁵⁰ Sam Jones, writing on ft.com/alphaville, highlighted this last sentence, describing it as a ‘thinly veiled threat’: ‘Full access – for now’.

See <http://ftalphaville.ft.com/blog/2010/03/11/172951/revealed-the-geithner-letter-to-eus-michael-barnier/>

imperil its position as the EU’s leading financial centre, the US making ominous gestures intended to secure access to the European market place for its large indigenous industry, and fund domiciles such as Luxembourg, Ireland and Malta lobbying to give a favourable spin to the Directive. These underlying agendas clearly influenced the reaction of the various stakeholders to the AIFMD, and must therefore be borne in mind when analysing the Directive.

4. Overview of the Directive

4.1. Introduction

Having analyzed the controversy and concerns surrounding the Directive during its development it is now possible to focus on the content of the Directive in its final form. Of course a detailed dissection of all the provisions of the Directive is beyond the scope of this paper; however I hope to provide sufficient information to allow the reader to form a clear idea of the measures being introduced. The final section of this paper will then look at the concerns that have just been analyzed in light of the provisions detailed below, and comment on whether any negative impact on the local hedge funds industry is to be expected.

4.2. Scope of the Directive

The AIFMD is more than a ‘hedge fund directive’.⁵¹ The

⁵¹ <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/572&type=HTML>

Directive covers the management of all collective investment undertakings which fall out of the scope of the UCITS regime.⁵² The Directive applies to:

- EU AIFMs which manage one or more AIFs irrespective of whether such AIFs are EU AIFs or non-EU AIFs;
- non-EU AIFMs which manage one or more EU AIFs;
- non-EU AIFMs which market one or more AIFs in the Union irrespective of whether such AIFs are EU AIFs or non-EU AIFs.⁵³

The Directive includes a *de minimis* provision: AIFMs which manage portfolios of AIFs whose assets under management, including any assets acquired through use of leverage, in total do not exceed a threshold of EUR 100 million or do not exceed a threshold of EUR 500 million (when the portfolios of AIFs are unleveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF) are not subject to the Directive unless they choose to opt in.⁵⁴

4.3. Remuneration

The Directive requires AIFMs to ensure that remuneration practices do not create incentives for excessive risk-taking. AIFMs are to establish and maintain remuneration policies and practices

⁵² Article 2

⁵³ Art. 2 (1)

⁵⁴ Art. 3 (2) (a), (b)

that are consistent with the sound and effective risk management policies laid down in Annex II of the Directive.⁵⁵

4.4. Valuation

AIFMs are required to put in place appropriate and consistent procedures in order to ensure that proper and independent valuation of the assets of the AIF⁵⁶ can be performed for each AIF that they manage at least once a year.⁵⁷ The rules applicable to the valuation of assets and the calculation of the net asset value per unit or share of the AIF which must be complied with are those laid down in the law of the country where the AIF is established and/or in the AIF's rules or instruments of incorporation.⁵⁸ The valuation function may be either performed by an external valuer which is independent from the AIF, the AIFM and any other persons with close links to the AIF or the AIFM itself as long as the valuation process is independent of the portfolio management and remuneration policies of the AIF and that measures are in place to identify and resolve conflicts of interest.⁵⁹

4.5. Conduct of Business Requirements

The Directive regulates conflicts of interest, risk management, liquidity management and investments in securitization positions. Organisational arrangements must be in place in

⁵⁵ Art. 13

⁵⁶ Art 19 (1)

⁵⁷ Art 19 (3)

⁵⁸ Art.19 (1), (2).

⁵⁹ Art.19(4).

order to identify, prevent, manage and monitor conflicts of interest that may arise between the AIFM and the AIF. Conflicts of interest must be disclosed to the investors if the risk of damage to the investors' interests may not be prevented;⁶⁰ risk management and portfolio management functions must be kept separate.⁶¹ AIFMs must also conduct stress tests and monitor the liquidity risk of open-ended funds regularly.⁶²

4.6. Leverage

The AIFMD introduces transparency requirements in relation to the use of leverage by AIFMs. An AIFM must set and comply with reasonable leverage limits for each Fund that it manages and is required to inform the competent authorities about its use of leverage so that the authorities can assess whether the use of leverage by the AIFM contributes to the build-up of systemic risk in the financial system.

The competent authorities have the power to intervene and impose limits on leverage when deemed necessary in order to ensure the stability and integrity of the financial system.⁶³

4.7. Asset Stripping

The Directive imposes restrictions on distributions (which includes dividends and interest on shares), capital reductions, share redemptions or acquisitions of own shares during the first two years

after an AIF has acquired control of a non-listed company. An AIF is deemed to have acquired control if it holds more than 50% of the voting rights of the company. The AIFM is bound for a period of 24 months following the AIF's acquisition of control of the non-listed company, not to facilitate, support or instruct or vote in favour of any distribution, capital reduction, share redemption and/or acquisition of own shares by the company; the AIFM must use its best efforts to prevent asset stripping.⁶⁴

4.8. Disclosure and Transparency Requirements

The AIFMD also specifies a number of disclosure and transparency requirements. An AIFM must provide its investors with information about the Fund, including *inter alia* its investment strategy and objectives of the AIF, the type of assets the AIF may invest in, any applicable investment restrictions, the circumstances in which the AIF may use leverage and the maximum level of leverage employable by the AIFM, the types and sources of leverage permitted and the associated risks and any restrictions on the use of leverage; its valuation procedures, any descriptions of preferential treatment and a description of all fees, charges and expenses.⁶⁵

4.9. The Depositary

AIFMs must appoint a single depositary for each of their funds.⁶⁶ The depositary is entrusted with the

⁶⁰ Art.14.

⁶¹ Art.15.

⁶² Art.16(1).

⁶³ Art.25

⁶⁴ Art.30

⁶⁵ Art.23

⁶⁶ Art.21(1)

custody of the assets of the AIF or the AIFM acting on behalf of the AIF for the purpose of safekeeping.⁶⁷ Only specified entities (such as authorized credit institutions) can be appointed depositaries.⁶⁸ Depositaries are liable to the AIF or to the investors of the AIF in the event of a loss of assets and for all other losses suffered by them as a result of the depositary's negligent or intentional failure to properly fulfil its obligations pursuant to the Directive.⁶⁹

In the case of EU AIFs, the depositary must be established in the home Member State of the AIF. For non-EU AIFs the depositary must be established in the third country where the non-EU AIF was established or in the AIFM's home Member State or in the Member State of reference of the AIFM managing the AIF.⁷⁰

4.10. Marketing of Funds: EU AIFMS marketing EU AIFs

The Directive introduces the possibility for AIFMs to 'passport' their services throughout the EU on the basis of a single authorisation. Once an AIFM is authorised under the Directive in one Member State the AIFM is entitled upon notification to manage or market funds to professional investors throughout the EU.

The EU AIFM is required to notify the competent authority of its home Member State in respect of each EU AIF that it intends to market.⁷¹ The competent authority

⁶⁷ Art.21(8)

⁶⁸ Art.21(3)

⁶⁹ Art.21(12).

⁷⁰ Art.21(5)

⁷¹ Art.32(2).

of the home Member State is bound to notify the AIFM of its decision as to whether the AIFM may start marketing the AIF in the home Member State of the AIFM, within 20 working days following receipt of the AIFM's notification as to its intention to market funds.⁷²

4.11. Marketing of Funds: EU AIFM marketing non-EU AIFs with a passport

An authorised EU AIFM may market with a passport non-EU AIFs (and feeder EU AIFs that invest primarily in non-EU AIF) that it manages as long as the following conditions are satisfied:

- the AIFM complies with the Directive;
- satisfactory cooperation agreements are in place between the competent authorities of the AIFM's home Member State and the supervisory authorities of the country of establishment of the non-EU AIF;
- the country of establishment of the non-EU AIF is not on the list of Non-Cooperative Countries and Territories by the Financial Action Task Force on anti-money laundering and terrorist financing;
- the country of establishment of the non-EU AIF has signed a OECD compliant tax treaty with the relevant AIFM's home Member State and with any other

⁷² Art.31(3).

Member State in which it is intended that the non-EU AIF will be marketed.⁷³

4.12. Marketing of Funds: EU AIFMs marketing non-EU AIFs without a passport

Individual Member States may, but are not required, to allow an authorised EU AIFM to market non-EU AIFs falling outside of the passporting regime as long as three conditions are satisfied, namely:

- the AIFM complies with the requirements of the Directive, except for the significant majority of the depositary requirements.
- appropriate cooperation arrangements for the exchange of information are in place between the competent authorities of the AIFM's home Member State and the supervisory authorities of the country of establishment of the non-EU AIF; and
- the country of establishment of the non-EU AIF is not contained on the list of Non-Cooperative Countries and Territories by the Financial Action Task Force on anti-money laundering and terrorist financing.⁷⁴

Individual Member States may impose stricter rules on the marketing of non-EU AIFs without a passport.⁷⁵

⁷³ Art.35(2)

⁷⁴ Art.36 (1)

⁷⁵ Art.36 (2)

4.13. Marketing of Funds: EU AIFMs managing non-EU AIFs

An EU AIFM which is authorized under the Directive may manage a non-EU AIF which is not marketed in the EU as long as it satisfies two conditions, namely:

- the EU AIFM must comply with all of the provisions in the Directive except the depositary requirements and the annual report requirements.
- Appropriate cooperation agreements must be in place between the Competent Authority of the AIFM's home Member State and the supervisory authorities of the country where the non-EU AIF is established for exchange of information.⁷⁶

4.14. Non-EU based Alternative Investment Fund Managers

The Directive seeks to subject all AIFMs active in the EU to the same high standards of transparency and conduct, irrespective of where the AIFMs or the funds they manage, are established. The Directive applies to non-EU AIFMs to the extent that they intend to either: (i) market one or more AIF in the EU (irrespective of whether or not the AIF is an EU based or non-EU based AIF) or (ii) manage one or more EU AIF.

⁷⁶ Art.34(1)

4.15. Non- EU AIFMs managing EU AIFS and/or marketing AIFS managed by them in the EU

Non-EU AIFMs intending to manage EU AIFs and/ or market AIFs managed by them in the Union require prior authorisation by the competent authorities of their Member State of reference⁷⁷ and must have a legal representative established in the Member State of reference who will be the contact point of the AIFM in the EU.⁷⁸ The Member State of reference is essentially the Member State with which the AIFM has its closest connection. A detailed analysis of the relevant rules is beyond the scope of this paper.

A number of conditions must be satisfied in order for the non-EU AIFM to obtain authorisation, including the existence of an OECD compliant tax treaty between the AIFM's country of establishment and the AIFM's Member State of reference.⁷⁹ A non-EU AIFM must comply with the Directive unless the AIFM is able to demonstrate that certain conditions apply.⁸⁰

4.16. Non-EU AIFMs managing AIFS established in Member States other than the Member State of reference

An authorised non-EU AIFM is allowed to manage EU AIFs established in Member States other than the AIFM's Member State of reference provided the AIFM provides its Member State of reference with details of:

- the Member State in which it intends to manage AIF directly or establish a branch;
- a programme of its intended operations and the services it intends to perform together with details of the AIFM that it intends to manage.⁸¹

If a branch is to be established, additional details must be provided in relation to the intended branch.⁸²

4.17. Non-EU AIFMs marketing EU AIFS with a passport

A duly authorized non-EU AIFM may market EU AIFs with a passport.⁸³ A non-EU AIFM which is authorised under the Directive must submit a complete notification file to the competent authorities of its Member State of reference for each EU AIF that it intends to market in its territory.⁸⁴

The relevant competent authorities are required, within 20 working days of receipt of the complete notification file, to inform the AIFM whether it may start marketing the AIF in its territory. The competent authorities may only prevent the marketing of the AIF if the AIFM's management of the AIF will not be in accordance with the Directive.⁸⁵ If the AIFM intends to market the AIF in other Member States, it must also inform the competent authorities of its Member State of reference in this regard.⁸⁶

⁷⁷ Art.37(1)

⁷⁸ Art.37(3)

⁷⁹ Art.37(7)

⁸⁰ Art.37(2)

⁸¹ Art.41(2).

⁸² Art.41(3).

⁸³ Art.39(1)

⁸⁴ Art.39(2)

⁸⁵ Art.39(3)

⁸⁶ Art.39(4)

4.18. Non-EU AIFMs marketing Non-EU AIFs

The Directive as adopted extends the passport to the marketing of non-EU funds, managed by AIFMs based outside the EU in order to ensure a level playing field and a high level of transparency and protection of European investors. A non-EU AIFM can market non-EU AIFs with a passport provided it satisfies the following conditions:

- the AIFM complies with the Directive;
- satisfactory cooperation agreements must be in place between the competent authorities of the AIFM's Member State of reference and the supervisory authorities of the country of establishment of the non-EU AIF;
- the country of establishment of the non-EU AIF is not on the list of Non-Cooperative Countries and Territories by the Financial Action Task Force on anti-money laundering and terrorist financing;
- the country of establishment of the non-EU AIF has signed a OECD compliant tax treaty with the relevant AIFM's home Member State and with any other Member State in which it is intended that the non-EU AIF will be marketed.⁸⁷

⁸⁷ Art.40(2)

5. How will the Local Industry Be Impacted?

Having discussed the various concerns that were raised with respect to the Directive and briefly surveyed the actual provisions which the Directives implements, I now move on to consider whether those concerns can be expected to materialize through the provisions in a manner which is harmful to the local hedge funds industry.

5.1. The De Minimis Rule

The first thing that needs to be noted is that in Malta the Directive's edge is likely to be blunted quite considerably by the application of the De Minimis rule. The jurisdiction has primarily succeeded in attracting interest from smaller fund managers with total assets under management inferior to the EUR 100m threshold established in the Directive.⁸⁸

This is important because it means that many of the fund managers which are established in the jurisdiction will not need to bear the additional regulatory burden which the Directive introduces. The other side of the bargain is that such AIF will not benefit from the passporting rights. In my view this has fairly limited importance as a disadvantage: these funds are already in a position where they do not have passport rights, and should they consider it beneficial to obtain a passport they can opt in by assuming the higher levels of regulation established by the Directive.

⁸⁸ 'Skills, speed and cost lift Malta's global profile', *Hedgeweek*, 30th August 2011

5.2. No Big News

Those funds that will fall to be regulated under the Directive (or choose to be so regulated) will take comfort from the fact that the many of the Directive's rules are rather familiar. Malta has built its reputation as a hedge funds domicile by emphasizing 'firmness' as well as 'flexibility' and thus many of the provisions contained in the Directive are already present and correct in the Maltese rulebook. Thus the rules on, for example, fund administration already have their counterparts in local legislation.⁸⁹ Other rules, such as those regarding remuneration, may pose some kind of challenge but are unlikely to have a significant impact.

5.3. The Depositary

One AIFMD provision which may have a negative impact on the local funds industry is the rule that every AIF must appoint a depositary in the same jurisdiction in which it (the AIF) is established.⁹⁰ I will set aside for now the question of whether such a requirement is justified (persuasive arguments can be brought forward that this rule is unnecessary) and focus on the impact which it may have on the industry.

As noted above, Malta has been successful in attracting funds and their managers to its shores. This success has generally been matched by an equivalent growth in the network of funds services providers which constitutes the essential infrastructure required for

⁸⁹ See Investment Services Rules for Professional Investor Funds, Part B: Standard License Conditions

⁹⁰ Art.21(5)

any funds jurisdiction to thrive. A fairly wide choice of big name fund administrators and auditors as well as lawyers specializing in the funds and financial regulation can now be found in the jurisdiction. The same cannot be said of providers of depositary services. Only a limited number are present at the moment and not all are internationally recognized brand names.⁹¹

This may be problematic for the continued growth of the industry. Because of the AIFMD provision in question, if the local depositary infrastructure cannot support a fund the AIFM in question may have no choice except to domicile its AIF elsewhere. This may funnel business towards more mature fund domiciles which host service providers having the required know how or specialization; giving rise to a sort of intra-EU protectionism.

5.4. A Challenge and an Opportunity

The final text of the Directive is less protectionist and more in tune with the realities of the funds industry than the original April 2009 text. Nevertheless, many AIFM, both EU as well as non-EU are likely to be re-evaluating their domiciliation options in the coming years. Non-EU fund managers may find that an EU domicile gives them easier access to EU investors; others may deem an EU domicile to be unnecessary but will need to identify a suitable reference jurisdiction; both EU as well as non-EU AIFM may start looking for a jurisdiction which they can use as a central hub from where to passport their services and funds into the

⁹¹ Refer to www.mfsa.com.mt for a full list of license holders

rest of the EU; all of these scenarios are likely to arise.

Malta already has various characteristics which make it attractive as a hedge fund domicile, such as the attitude of the regulator, the general cost-effectiveness of the country, a competitive fiscal regime and an English speaking workforce. These characteristics have led to the growth that the country has achieved so far. During the various reviews of domiciliation status which the AIFMD will inevitably trigger, these characteristics are likely to place Malta among most shortlists.

At this stage I have to highlight that the situation is still somewhat fluid. The Directive's Level 2 implementing measures (which I have excluded from this discussion) are still being developed. Bold predictions are therefore likely to end in embarrassment for the would be clairvoyant. Nevertheless it is quite clear that the Directive will not, as may have initially been feared, threaten the survival of the local hedge funds industry. On the contrary, the coming into force of then Directive is likely to generate an important window of opportunity which, if exploited by the local authorities and industry, will help to further cement Malta's position as a leading funds domicile.