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# *EU Proposal on Regulation of Alternative Investment Fund Management*

2009-05-07

## **INTRODUCTION AND OUTLOOK**

Following the consultation process started in 2006 and accelerated by the impact of the current financial crisis, the EU Commission has adopted a proposal for a Directive on Alternative Investment Fund Managers (AIFM) on April 30, 2009. The proposed Directive aims to create a comprehensive framework for the direct regulation and supervision of the alternative fund industry throughout the EU, particularly targeting hedge funds and private equity. The proposal will now be sent to the European Parliament and the European Council where intense political discussion and negotiation are likely to follow. In spite of the political sensitivity of the issue, the Commission is currently seeking to adopt final legislation at the end of 2009, with transposition of the Directive into national law and entry into force throughout the EU planned for 2011.

The stated objectives of the AIFM Directive are to establish:

- Appropriate authorization and registration requirements for all AIFM providing management services within the EU;
- Effective monitoring of macro-prudential risks by enhancing EU-wide regulatory oversight;
- Robust risk management and organizational safeguards at the level of AIFM and key service providers;
- Better investor protection;
- Enhanced transparency, particularly with respect to private equity funds; and
- An EU passport for AIFM.

The proposed Directive is the first attempt worldwide to create a comprehensive regulatory framework for the alternative fund industry. The EU passport approach will permit alternative fund managers to market funds throughout the EU on the basis of a harmonized set of rules. This is obviously an advantage compared to the combination of fragmented national regulations and cross-cutting Community law that is currently in place. However, as initial reactions from both policymakers and targeted industry sectors show, the proposed Directive is highly controversial and will certainly be subject to further intense political discussion and negotiation in the upcoming legislative process. Given the track record of previous reforms to financial regulation at EU level, it

can be expected that final legislation will take longer to adopt than the Commission would wish, unless a strong and early political consensus emerges among a core group of EU member states. This may be unlikely in the near term, since German elections take place in September and French interim polls are due in the summer. In both countries, as well as elsewhere in the EU and throughout the world, reform of the regulatory framework to prevent a repeat financial crisis is seen as a top priority and will be a theme in rival political campaigns.

## **KEY ELEMENTS OF THE PROPOSED DIRECTIVE**

The main features of the proposal are as follows:

**Scope: Managers of non-UCITS funds would be covered.** The proposed Directive covers EU-based AIFM, i.e., managers of any collective investment undertaking of whatever legal form that is not authorized pursuant to the UCITS regime. (UCITS, or Undertakings for Collective Investment in Transferable Securities, are existing funds that are authorized to do business throughout the EU and that invest in regulated securities or more conventional instruments.) This means that managers of hedge funds, funds of hedge funds, private equity funds, commodity funds, real estate funds and infrastructure funds will be subject to regulation for the first time at the EU level.

Non-EU based AIFM would be permitted to opt into the scheme after a waiting period of three years following transposition of the Directive into national law. During this time, the AIFM and the third country in which it is domiciled would be required to establish the existence of an equivalent regulatory framework.

AIFM with assets of less than EUR 100 million under management are exempted from the scope of the proposal; a higher threshold of EUR 500 million would apply to AIFM that manage AIF that are not leveraged and lock in investors for five years following the date the fund was formed (i.e., private equity funds), since they are seen as creating less systemic risk. Exempted AIFM will not have any rights under the proposed Directive, unless they decide to opt into coverage. If not, they will remain subject to applicable national legislation.

The Commission estimates that roughly 30 percent of hedge fund managers with almost 90 percent of the assets held by EU-based hedge funds under management will be covered by the Directive.

**Fund managers require authorization.** Under the proposal, managers of AIF (and not the funds themselves) require authorization to provide AIF management services within the EU. This would be granted within two months if the regulatory authorities are satisfied that the manager fulfills the conditions of the Directive. With the exception of limitations on use of leverage and additional requirements for investments in securitized positions (see below), the proposal does not impose any restrictions on AIF investment policies. However, application for authorization requires certain disclosures, including the identities of all beneficiaries of the AIFM, the AIF that the manager intends to manage, the fund rules and information on how the manager intends to comply with the Directive.

In the authorization process, AIFM would be required to establish, among other things, that:

- They meet minimum capital requirements (EUR 125,000 plus 0.02% of the amount by which the value of the portfolio exceeds EUR 250 million);
- Sufficient risk management is in place, particularly with regard to liquidity risks and additional operational and counterparty risks associated with short selling;
- Conflicts of interest are adequately managed and fairly disclosed;
- Fair valuation of assets is ensured by an independent valuator; and
- Depository/custodian arrangements to ensure safekeeping of assets are secured.

Application for authorization must be made within one year following the deadline for transposition of the Directive into national law. On authorization, AIFM are entitled to provide AIF management services regarding EU-based AIF in their home member state and, following a notification procedure, in all other EU member states (EU passport). The managers are further allowed to manage AIF domiciled in third countries after a period of three years following the deadline for transposition if certain prerequisites are met (see below).

**Authorization allows fund marketing only to professional investors.** The authorization does not entitle AIFM to market the shares or units of AIF under management to retail investors. AIFM must inform the regulator about the safeguards established to prevent units or shares of an AIF from being marketed to retail investors. However, individual EU member states may establish or maintain regulatory regimes that allow AIF to be sold to retail investors within their jurisdiction.

**EU management and marketing of third country AIF, and, authorization of third country managers in the EU, require an equivalent regulatory framework.** The proposed Directive permits EU-based AIFM to manage and market AIF domiciled in third countries subject to strict conditions. Generally, such cross-border marketing requires that the AIF country of domicile comply with the OECD Model Tax Convention and thereby ensure that national tax authorities may obtain all information necessary to tax domestic professional investors investing in offshore funds. In addition, the proposal also defines the conditions (regulatory and supervisory equivalence) under which certain key functions can be undertaken by third-country entities. In particular, EU-based depositaries are only allowed to sub-delegate functions to a third-country depositary under strict conditions, and valuers appointed in third-country domiciles must be subject to equivalent regulatory standards. Finally, member states may authorize non-EU AIFM in accordance with the Directive, provided that the third country effectively enforces prudential regulation and ongoing supervision of AIF equivalent to the Directive and grants EU-based AIFM effective market access comparable to that granted to third-country AIFM.

The third-country aspects of the proposed Directive require that the Commission adopt further implementing measures specifying the criteria for assessing regulatory and supervisory equivalence. The proposal therefore provides for a period of three years after it is transposed in the EU during which such implementing measures are to be adopted. The European Commission will have the authority to decide on the equivalence of third-country regulation and supervision as well

as comparable market access for EU-based AIFM. During this three-year implementation period, member states may continue to allow AIFM to market third-country AIF subject to national law.

**Proposal deals primarily with operating conditions and transparency requirements.** The proposed Directive regulates operations (capital requirements, organizational requirements, issues of delegation and conduct of business) and mandates certain transparency requirements (annual reporting, disclosures to investors and competent authorities, additional requirements for AIFM managing leveraged AIF or AIF acquiring controlling stakes in companies). The proposal does not contain any tax provisions or bans on particular investment strategies (e.g., on "naked" short-selling or use of stock borrowing or other instruments to build a stake in a target company).

**Proposal does restrict leverage and impose conditions on securitization.** The proposed Directive does impose conditions on certain types of investment policies: First, the Commission is to implement measures limiting the levels of leverage AIFM can employ to ensure the stability and integrity of the financial system. The limits would depend on the type of AIF, the investment strategy and the sources of leverage. Second, the Commission is to implement requirements for originators, i.e. firms that repackage loans into tradeable securities and other financial instruments, which originators will have to meet so that AIFM may invest in such financial instruments after 1 January 2011. The Commission would also have to establish qualitative requirements for AIFM that invest in such financial instruments. One condition for originators is that they would be required to retain a net economic interest of not less than five percent in any securitized positions. The proposed Directive would extend these requirements to UCITS as well.

**Fair treatment of investors.** Even though marketing of AIF will be limited to professional investors, the proposed Directive would establish certain requirements for fair treatment of investors. AIFM will be required to disclose sufficiently detailed information, including annual audited reports, to allow for a minimum of investor protection. Disclosure will have to be provided on the following:

- The investment strategy and objectives of the AIF, all the assets the AIF can invest in, the techniques it may employ and all associated risks including a description of applicable investment restrictions and levels of leverage used;
- The procedures by which the AIF may change its investment strategy and/or policy;
- Redemption policy;
- Risk management procedures and custody/depositary/delegation arrangements;
- Fees, costs and charges incurred in connection with an investment; and
- A description of any preferential treatment given to particular investors.

**Managers of AIF will be required to report on their investments to regulators.** Regular reporting to the competent authorities will be required on the principal markets and instruments in which the AIFM trades, including principal exposures and important fund concentrations. Periodic reporting is required particularly with regard to valuation, liquidity management, actual risk and investment profiles, as well as use of short selling. The Directive would authorize the European Commission to adopt implementing measures that further specify these reporting obligations, as well as their frequency.

**Additional transparency requirements will apply for managers of leveraged AIF and AIF acquiring controlling positions in companies.** Additional disclosure requirements in connection with these types of funds are justified, according to the explanatory memorandum accompanying the proposed Directive, by the systemic risk posed by high levels of leverage and the need for private equity and buy-out funds to publicly account for management changes after acquiring a controlling position.

In this regard, the proposed Directive would provide for the following requirements:

- *Leveraged AIF.* AIFM that manage funds employing high levels of leverage on a systematic basis are subject to additional reporting requirements both to investors and regulators. AIF will be deemed to fall within this category when combined leverage from all sources exceeds the value of the equity capital of the AIF in two out of the past four quarters. AIFM are to assess on a quarterly basis whether this threshold has been triggered and must inform the competent authorities accordingly.

Reporting to regulators must include information on aggregate leverage, the form of leverage (cash borrowing, securities borrowing, leverage embedded in derivatives) as well as the main sources of leverage (lending institutions such as prime brokers, banks, etc.). Member state regulators will share this information to identify any build-up of systemic risk due to high levels of leverage. The proposal would give them emergency powers to restrict leverage levels to ensure stability and integrity of the financial markets. Disclosures to investors must include general information on leverage levels and arrangements as well as periodic reporting of actual leverage in the preceding period. As discussed above, the proposed Directive will also give the Commission authority to set limits on the leverage that an AIFM may use, as well as national regulators in urgent situations.

- *AIF acquiring controlling positions.* The proposed Directive provides for specific notification and disclosure requirements for managers of AIF that can exercise a controlling or dominating influence over an EU company. The requirements are triggered when AIFM (i) manage one or more AIF which either individually or in the aggregate acquire 30% or more of the voting rights of a target or (ii) conclude an agreement with one or more other AIFM which would allow the AIF managed by these latter managers to acquire 30% or more of the voting rights of a target. A de minimis exception applies for investments in SMEs, i.e., non-listed companies with fewer than 250 employees, an annual turnover not exceeding EUR 50 million and/or an annual balance sheet total not exceeding EUR 43 million.

If the 30% percent threshold is triggered, a new notification requirement would apply for non-listed companies, and, for both non-listed as well as listed companies, AIFM will have to disclose information to the company, all its shareholders and the representatives of the employees about their intentions with regard to the future development of the business and other planned changes for the controlled entity. Further, additional information is required in the annual reports for AIF that have acquired such controlling positions. In the event of a delisting, reporting obligations that applied for a previously listed company remain in force for a period of two financial years.

## DISCUSSION

Initial reactions by both policymakers and targeted industry groups have indicated great concerns

with the proposal. The proposed Directive is likely to become a central issue in upcoming European parliamentary elections and will most likely be subject to significant amendments in the legislative process. Industry participants have complained that the draft legislation was drawn up with little or no industry input and without reference to other international organizations with responsibility for alternative fund regulation, including the newly-established Financial Stability Board and the International Organization of Securities Commissions. National policymakers, on the other hand, have labeled the proposal as "almost worthless," saying the proposed rules are "filled with loopholes" and would be "highly ineffective."

Points of criticism include the following:

- The proposed Directive would cover very different types of investment funds (e.g., including open-ended real estate funds, special funds, etc.). Industry groups have criticized what they see as an inappropriate "one size fits all" regulatory approach to such diverse investments.
- The proposal largely subjects private equity funds to the same set of rules as hedge funds. The private equity sector has criticized this as unjustified because it is generally accepted that private equity does not pose any systemic risk (see, e.g., findings of the EU Commission Open Hearing on Hedge Funds and Private Equity on February 26th and 27th 2009).
- Although the industry acknowledges the differentiated de minimis thresholds for applicability of the Directive as a significant improvement over an initial draft that provided only for a general exemption below EUR 250 million, private equity firms fear that overly stringent compliance requirements would penalize venture and mid-market funds. Conversely, policymakers consider the thresholds for applicability of the Directive to be far too high and are concerned about loopholes. Finally, it remains unclear how thresholds will be calculated (aggregation of master and/or feeder funds, net/gross test, relevant time period, valuation method, etc.).
- By regulating the managers and not the funds, the proposal accommodates a key concern of the Alternative Investment Management Association. But the hedge fund industry has already criticized the EU passport requirement for third country AIF (not included in an earlier draft) as too far reaching and unclear. In this context, it still remains to be seen whether the Commission's expectation that offshore financial centers will have a strong incentive to comply with the Directive proves correct.
- Since member states will not be allowed to impose additional requirements on AIF managers domiciled in another member state, the proposed Directive would effectively eliminate such restrictions currently in place at a national level (e.g., in certain member states hedge funds must diversify risk, others limit the marketing of cross-border hedge funds, etc.). However, details and scope for the European passport remain unclear, particularly where the proposed Directive is silent on an issue (e.g., would national requirements for prime brokers remain?).
- The definition of "professional investor," taken from the Markets in Financial Instruments Directive (MiFID), is seen as both over- and underinclusive for private equity investors, because under the "regular transaction" test certain sophisticated investors would not be

included but many SMEs would be included.

- Policymakers have criticized the failure of the proposal to address taxation and to limit investment strategies such as short-selling and dynamic trading, considered to have contributed to the financial crisis.

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