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Update on the European Directive to Regulate Alternative Investment Fund Managers

The European Commission's proposed Directive on Alternative Investment Fund Managers (the "Proposed Directive") continues to be fiercely debated across Europe. The Proposed Directive, which is currently the subject of high-level political negotiation, contemplates changes in regulation that would have significant implications for both EU and non-EU managers of all types of alternative fund. This memorandum highlights the latest developments as the Proposed Directive makes its way through the European legislative process.

Background

The official text of the draft Directive on Alternative Investment Fund Managers[1] was published on April 30, 2009. Initially, some in the alternative funds industry (and some politicians) were openly critical of the need for the Proposed Directive at all. Their position was bolstered by the fact that many of the provisions in the Proposed Directive either misunderstood the varying characteristics of different types of alternative investment fund, or were otherwise entirely unworkable. However, most commentators now accept that the Proposed Directive will be implemented in one form or another. The focus has therefore shifted to one of constructive dialogue as to the precise content of the Proposed Directive, with a view to ensuring that the final legislation does not have unintended or disproportionate consequences for the industry or for investors.

Key Proposals (including latest developments)

- **Compulsory authorization of fund managers located in the EU:** Managers located in the EU will require authorization from regulators in order to manage and market funds.[2] Once authorized, managers will be able to market EU funds across Europe to 'professional investors' (see below). Managers may be authorized to provide management services either for all types of fund or only for specific types.[3]

  As a general point, the Proposed Directive focuses its regulatory efforts on managers of funds rather than the funds themselves.

- **Fund managers located outside the EU may, in theory, be able to apply for a recognized status enabling them to market funds across Europe:** Three years after the rest of the Proposed Directive comes into force, managers located outside the EU may be able take advantage of the pan-European marketing passport described below, provided that the country in which the manager is located (i) meets

[1] Text available, along with press release and frequently asked questions, at http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm.

[2] Proposed Directive, Article 4.

[3] Proposed Directive, Article 4(2).

certain equivalent regulatory and information-sharing standards and (ii) offers equivalent access to its markets for EU-based managers.[4] It appears that failure to offer that equivalent access may result in non-EU managers being unable to market their funds in Europe at all.

The issue of non-EU managers having access to the EU investor base has been the subject of enormous debate since the Proposed Directive was first published. Many commentators believe that equivalence requirements set by the European Commission would be unlikely to be met by some jurisdictions (including the U.S.). The Proposed Directive has therefore been criticized as seeking to impose global standards on non-EU jurisdictions.[5]

At this stage, it is impossible to know whether the 'blanket ban' on non-EU managers accessing the EU market - unless equivalence requirements are met - will be retained. It remains a possibility that the Proposed Directive will be amended to:

- retain, in some form, the existing EU private placement regime, whereby non-EU managers can promote their funds into EU Member States in accordance with the particular rules in those Member States (which vary considerably); and/or

- permit EU institutional investors to invest in such funds where the investment is the result of an approach by the investor itself (i.e. no solicitation has occurred).

- **Alternative investment funds**: The Proposed Directive applies to managers of "alternative investment funds": that is, funds (including hedge funds and private equity funds located anywhere in the world) that are not required to be regulated under the UCITS Directive.[6] UCITS funds are, essentially, European-regulated retail funds which can be freely marketed across Europe to retail and other investors.

  The definition of "alternative investment funds" is extremely broad. As well as hedge funds and private equity funds, many real estate funds and non-UCITS long-only funds will be captured. Because the Proposed Directive does not exclude funds that are equivalent to UCITS funds, even funds such as mutual funds in the United States would appear to fall within the definition.

  It is clear that the Commission crafted a wide definition of "alternative investment fund" with the intention of limiting any future structuring (or restructuring) of funds in order to fall outside the scope of the Proposed Directive. However, the Presidency of the European Council has recently noted that the breadth of the existing definition could capture some funds that clearly should not be the target of the Proposed Directive.[7] The definition may well, therefore, be amended so as to avoid capturing (for example) non-UCITS retail funds. It is less likely that any amendment will exempt other broad categories of fund, such as closed-end funds.

- **De minimis exemptions**: The Proposed Directive does not apply to managers of small funds. For this purpose, different thresholds are effectively applied to private equity funds and hedge funds. Generally, the Proposed Directive applies to fund managers who are managing funds with more than €100 million of assets under management. However, there is a further exemption - mostly benefiting private equity fund managers - for those managing funds with less than €500 million of assets under management,

[4] Proposed Directive, Articles 39 and 54.

[5] See, for example, quotes attributed to David Vaughan, senior fellow at the SEC in "U.S. and EU clash over protectionist hedge fund law", Reuters, September 17, 2009, text available at http://www.reuters.com/article/hedgeFundsNews/idUSLNE58G02M20090917

[6] Proposed Directive, Articles 2 and 3. Directive 1985/611/EEC. The recast UCITS Directive, referred to in the Proposed Directive as "Directive 2009/…/EC", was adopted on July 13, 2009 as Directive 2009/65/EC.

[7] See the "Issues Note" published by the Presidency of the European Council on September 2, 2009, text available at http://register.consilium.europa.eu/pdf/en/09/st12/st12864.en09.pdf

which do not use leverage and which lock investors in for at least five years.[8]

The Presidency of the European Council has recently highlighted some concerns about these thresholds, in particular querying how the thresholds would operate in practice given that the value of a fund's assets can fluctuate (and therefore a manager could fall below or above the threshold for authorization at different times).[9] Some voices support a removal of the *de minimis* exemptions entirely, but only on the assumption that other areas of the Proposed Directive are amended so that the smaller managers are not subject to unnecessarily burdensome requirements.[10]

- **Once authorized, managers can market EU domiciled funds to "professional investors"**:[11] In addition, Member States would be able to decide on an individual basis whether to allow managers to market such funds to retail investors.[12]
- **Marketing of non-EU domiciled funds by authorized managers**:[13] Authorized managers will also be able to market non-EU domiciled funds to "professional investors" (but, unlike for EU-based funds, apparently not to retail investors even if Member States wish to allow this). However, this will only be possible (i) three years after the final date by which Member States must implement the rest of the Proposed Directive and (ii) if the jurisdiction in which the non-EU domiciled fund is based has entered into an agreement with the relevant Member State where the investors are located which complies with the OECD Model Tax Convention (i.e. the exchange of tax information between authorities).

  In the meantime, non-EU domiciled funds can continue to be marketed in Member States to the extent currently permitted. This varies from country to country.
- **Authorization conditions**: In order to become authorized, managers will need to demonstrate that they are suitably qualified and have various risk management arrangements in place. Managers will be subject to general requirements to act honestly, fairly and with due skill, care and diligence. As well as acting in the best interests of its funds and investors in those funds, managers will also be expected to act in the best interests of the "integrity of the market", although there is no suggestion as to what that means.[14]
- **Information be provided as part of the authorization process**: Information to be supplied prior to authorization includes the planned activity, location and characteristics of the funds to be managed (including the instruments of incorporation and fund rules), the identities of shareholders in the manager that hold 10% or more of the capital and the amounts held by any such shareholders, governance mechanisms and arrangements for delegation and safe-keeping of assets.[15]
- **Service providers and delegation**: The Proposed Directive seeks to ensure that key service providers, such as depositories, are also subject to appropriate regulation.[16] Independent valuers (termed "valuators") of fund assets must be appointed. Any delegation of functions by the manager is subject to prior authorization by the regulator where the fund manager is incorporated. In addition, a manager's liability

8 Proposed Directive, Article 2(2).

9 See the 'Issues Note' published by the Presidency of the European Council on September 2, 2009 (link provided above in footnote 7).

10 The industry body AIMA supports the regulation of all fund managers, regardless of assets under management. However, AIMA also considers that only those managing assets in excess of €1 billion should be required to disclose detailed information to regulators (AIMA's Position Paper, published on 21 September 2009. An Executive Summary is available at http://www.aima.org/en/document-summary/index.cfm/docid/0E8C0F1B-8DAF-478F-B9C8DDF012839DF9).

11 Proposed Directive, Article 2(1). "Professional Investors" has the meaning set out in the Markets in Financial Instruments Directive (Directive 2004/39/EC).

12 Proposed Directive, Article 32.

13 Proposed Directive, Article 32.

14 Proposed Directive, Articles 9 -13.

15 Proposed Directive, Article 5.

16 Proposed Directive, Article 17.

will not be affected by the fact that it has delegated functions to a third party. [17]

Under the Proposed Directive, all funds managed by authorized managers would be required to appoint an EU credit institution as depositary. Depositaries would not be able to exclude liability for the acts or omissions of any persons to whom they delegate.

The provisions relating to depositaries in the current draft of the Proposed Directive are not workable. The requirement that only EU credit institutions be appointed as depositaries on a strict liability basis does not reflect the nature of global custody and prime brokerage relationships (and many of the largest prime brokers are not EU credit institutions). In addition, the Proposed Directive does not seem to appreciate the need in some jurisdictions to hold assets with local custodians.

Fortunately, there now seems to be broad acceptance that the Proposed Directive is deficient in this regard[18] and it appears very likely that the provisions relating to depositaries will be amended. One possibility is that EU authorised investment firms, rather than just EU credit institutions, will be capable of being appointed as depositaries. Separately, there is an ongoing consultation in relation to the extent of liability of depositaries under the UCITS Directive and it is likely that the results of that consultation will be taken into consideration when the Proposed Directive is amended.

- **Minimum capital requirements for authorized fund managers:** Managers will be required to hold and retain a minimum level of capital of at least €125,000, plus 0.02% of the amount by which the value of the manager's portfolios exceeds €250 million.[19]

[17] Proposed Directive, Article 18.

[18] See the 'Issues Note' published by the Presidency of the European Council on September 2, 2009 (link provided above in footnote 7).

[19] Proposed Directive, Article 14.

- **Pre-investment and ongoing disclosures to investors**: Investors must be provided with a wealth of information (some of which will already be provided by managers in offering documentation as a matter of course), including a description of the fund's objectives and investment strategy, assets in which the fund may invest, investment restrictions, details of the circumstances in which leverage may be used, the types and sources of leverage permitted and any associated risks or restrictions. Investors must also be provided with a description of the procedures by which the fund may change its investment strategy or policy, details of any delegation and of any service providers, a description of all fees, charges and expenses borne by investors, including the maximum amounts of any such expenses. Of particular interest to hedge funds that have previously entered into side-letter agreements with certain investors is that the identity of any investor receiving preferential treatment – and details of that preferential treatment – must be disclosed to other investors.[20]

- **Ongoing reporting obligations to regulatory authorities**: Information to be reported includes (i) the main markets and instruments in which the manager trades, (ii) the principal exposures of the manager's funds, (iii) the percentage of any fund's assets that are illiquid, (iv) the main categories of assets in which any fund is invested and (v) their use of short selling.[21]

  These provisions of the Proposed Directive could lead to an impracticably large amount of data being reported to regulators, much of it being of no relevance for assessing systemic risk. The consequence of that overload of data could be that the ability accurately to assess systemic risk is diminished rather than enhanced. As a result, some have suggested that reporting obligations only be imposed on those managing assets above

[20] Proposed Directive, Article 20.

[21] Proposed Directive, Article 21.

a relatively high threshold (AIMA has suggested €1 billion).[22]

- **Additional disclosure obligations for managers engaging in high levels of leverage (and limits on leverage)**: The additional disclosure obligations only apply where the amount of leverage employed exceeds the value of the fund's equity capital.[23] These obligations are therefore likely to be most relevant for hedge fund managers. Managers must disclose both to regulators and investors the maximum level of leverage that will usually be employed and, on a quarterly basis, the total amount of leverage actually employed by the fund.[24]

  Although limits on leverage are not contained in the Proposed Directive, it is stated that rules will be introduced that limit the leverage which managers may employ, depending on the nature of the underlying fund.[25]

  Whether limits on leverage should be included in the Proposed Directive at all is the subject of continuing discussion and debate. There remains a possibility that the idea of rules to set out blanket limits on leverage in all market conditions will be dropped entirely from the Proposed Directive. However, the Proposed Directive also contemplates that regulators in each Member State should be entitled to impose temporary leverage limits in exceptional market conditions, and this is expected to be retained in any redraft of the Proposed Directive.

- **Additional disclosure and other obligations for managers holding a controlling influence in larger issuers or non-listed companies**: These additional obligations are likely to be of most relevance for private equity funds. Where a manager is in a position to exercise 30% or more of the voting rights of an issuer (essentially, a listed company) or non-listed company domiciled in the EU, the manager will be required to (i) notify the company and its shareholders of this and (ii) provide them all with related information, including the resulting situation in terms of voting rights, the conditions under which the 30% threshold has been reached and the date on which it was reached.[26] These additional requirements do not apply where the issuer or non-listed company employs fewer than 250 persons, has an annual turnover not exceeding €50 million and/or an annual balance sheet total not exceeding €43 million.[27]

  Shareholders of such an issuer or non-listed company, and its employees (or their representatives), must also be provided by the manager with, among other things, a development plan for the company and a policy for communicating with employees.[28]

- **Other "third country" provisions (only applicable three years after the final date by which Member States must implement the rest of the Proposed Directive)**: The Proposed Directive contains additional requirements for managers wishing to appoint administrators or valuers of fund assets domiciled outside the EU (in a "third country"). The administrator or valuer must meet the requirements applicable to all EU administrators and valuers. Furthermore, the third country must have regulatory/valuation standards that are broadly equivalent to those in the EU. EU depositaries wishing to delegate to non-EU sub-depositaries located in the same jurisdiction as the fund itself may do so, provided those sub-depositaries are regulated to EU-equivalent standards.

22 See AIMA's Position Paper, published on September 21, 2009 (link to the Executive Summary is provided above in footnote 10). At a conference held on September 17, 2009 and hosted by the United Kingdom's Financial Services Authority (the "FSA"), the FSA appeared to agree that the volume of data contemplated by the Proposed Directive could in fact be so large that the disclosures would be counterproductive.

23 Proposed Directive, Article 22.

24 Proposed Directive, Article 23.

25 Proposed Directive, Article 25.

26 Proposed Directive, Article 27.

27 Proposed Directive, Article 26(2).

28 Proposed Directive, Article 28.

Commentary

"Smell the coffee! There is going to be a directive." That was the blunt message of Lord Myners[29] to the alternatives industry at a conference hosted by the UK's Financial Services Authority on September 17, 2009. The political impetus for the Proposed Directive looks unstoppable. But, at the same time, there is a growing consensus across the EU that the current draft of the Proposed Directive is unworkable and will require major surgery if it is to be fit for its intended purpose. It has been suggested that in the region of 1,000 amendments could be proposed by members of the European Parliament.[30]

Industry bodies continue actively to campaign to try and ensure that the Proposed Directive is amended in a way that reflects how funds are structured and operate in practice and with a view to ensuring that the Proposed Directive does not end up damaging the EU alternatives industry or EU investors. This approach is consistent with the Commission's request for constructive criticism, it having been made clear that continuing calls for the Proposed Directive to be shelved entirely would fall on deaf ears.[31]

When the Proposed Directive was first published in April 2009, it was envisaged that formal adoption could take place by the end of 2009, with implementation of the Proposed Directive across Europe by the end of 2011. Perhaps inevitably, given the extent to which the Proposed Directive's provisions are perceived as being deficient, the timing has slipped. It now looks as though the Proposed Directive is unlikely to be adopted before the middle of 2010 at the earliest, with implementation across Europe taking place during 2012. Encouragingly, the Commission has acknowledged the importance of getting the Proposed Directive "right", rather than rushing its implementation through.[32]

Despite what appeared originally to be intractable differences of opinion between Member States as to the level of regulation that the Proposed Directive should take, there is increasing optimism that common ground is being reached. Jean-Pierre Jouyet, chairman of Autorité des Marchés Financiers, the French regulator, recently appeared to agree that blocking non-EU fund managers out of the EU investor market entirely would be a mistake.[33]

It should not, however, be taken for granted that the Proposed Directive will eventually allow non-EU managers to continue to be allowed to market their funds to EU investors (whether on the basis of the current Member State by Member State private placement regime or otherwise). Nor should it be assumed that the Proposed Directive will eventually be 'watered down' in ways that meet the industry's other concerns. While there is increasingly convergence between the views of various key Member States on certain issues, strong differences of opinion remain. As the Proposed Directive progresses through the European legislative process, it will be essential for industry bodies, managers, their advisers and investors to continue to make the case for appropriate, workable legislation.

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29 Financial Services Secretary to the UK Treasury and City Minister, UK Government. See "U.S. and EU clash over protectionist hedge fund law", Reuters, September 17, 2009, text available at http://www.reuters.com/article/hedgeFundsNews/idUSLNE58G02M20090917

30 See "Reflections on the economic crisis and EU response", by Peter Skinner MEP, text available at http://www.peterskinnermep.eu/index.php?option=com_content&task=view&id=330&Itemid=27

31 According to David Wright, Internal Market & Financial Services DG at the European Commission, speaking at the FSA's conference held on September 17, 2009.

32 Per David Wright, speaking at the FSA's conference held on September 17,2009.

33 Speaking at the FSA's conference held on September 17, 2009. Jean-Pierre Jouyet encouragingly saw convergences of opinion between France and the United Kingdom on a number of areas. See "Universal regulation will not 'hurt City of London'", FinancialAdvisor, September 24, 2009, text available at http://www.ftadviser.com/FinancialAdviser/Regulation/Regulators/FSA/News/article/20090924/d590c946-a3a6-11de-9922-0015171400aa/Universal-regulation-will-not-hurt-City-of-London.jsp

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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