Private fund manager regulation: US and European initiatives compared

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Abstract

The recent financial crisis continues to drive governmental and regulatory actions across the globe. Among them are proposals in both the USA and Europe that are likely to directly extend the regulatory oversight of private fund managers. This paper highlights the current registration requirements for private fund managers in the USA and the UK (the two largest domiciles for private fund managers), before analysing how proposed regulatory reform in the USA and Europe will affect the status quo.

Keywords: hedge fund, private equity fund, fund manager, investment adviser, regulation, registration, EU, SEC

INTRODUCTION

The financial crisis has seen governments around the world seek to develop an improved financial regulatory environment, and — with the Madoff scandal dominating headlines for several months — private fund managers did not escape the attention of lawmakers as they crafted their overhaul proposals.[1] In both the USA and the EU, legislation has been proposed that would extend the regulatory obligations of managers to private funds, especially in the areas of regulatory registration/authorisation, custody of client assets, ongoing reporting, and scope of regulatory inspections.

A 'private fund', by way of background, is an investment fund that —

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unlike a mutual fund or regulated collective investment scheme — avoids public registration and typically limits its investors to those qualified by applicable securities laws to invest outside the retail markets. Many US-domiciled private fund managers currently rely on an exemption to avoid registering with the Securities and Exchange Commission (SEC) as an investment adviser. In the UK, by way of contrast, private fund managers have long been required to become authorised by the Financial Services Authority (FSA).

Part 1 of this paper outlines the current regulation of private fund managers both in the USA and the UK, and notes that there is currently no pan-European regulation of private fund managers. Part 2 then looks at proposed new legislation in the USA and how that would affect the status quo, both for US and non-US fund managers. Generally, the US approach will register with the SEC many now unregistered fund managers. Part 3 focuses on the proposed European Alternative Investment Fund Managers Directive and its implications for managers located both in and outside the EU. While there is a split in approach between the two regulatory bodies crafting the new rules, the proposals could fundamentally change how non-US fund managers and non-US private funds operate in Europe.

PART 1 — THE STATUS QUO

Current regulation of private fund managers in the USA

Requirement to register with the SEC and an introduction to the 'Private Adviser' exemption

Unless an exemption applies, any 'investment adviser' doing business in the USA or dealing with US persons as clients is required to register under the Investment Advisers Act of 1940 (the 'Advisers Act'). An 'investment adviser' is, in pertinent part:

> 'any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.'[2]

On its face, this definition captures most private fund managers. In the absence of an exemption, any such manager is therefore required to register with either the SEC or (except for non-US managers, to the extent that the manager's assets under management total less than US$25m) with applicable US state securities regulators. The remainder of Part 1 assumes that registration with the SEC, as opposed to the states, would be required.

The principal exemption that fund managers wishing to avoid US registration under the Advisers Act have relied on to date is the so-called 'private adviser' exemption, which allows an investment adviser to opt out of registration with the SEC, so long as the firm:

- does not 'hold itself out' to the public in the USA as an investment adviser; and
- over a rolling 12-month period, services 14 or fewer 'clients' (with a fund typically counted as a single client).

As discussed in Part 2 below, the private adviser exemption is to be repealed under pending US legislation.

Registration with the SEC

When an exemption is not available (or an investment adviser chooses to register despite the availability of an exemption), the investment adviser must file with the SEC a completed Form ADV, together with a nominal fee. Following filing of the Form ADV, the SEC is required to approve or reject the application within 45 days — a timeline that compares favourably with the statutory six-month period that the FSA has to determine an application for registration in the UK.

That is not to say, however, that the process of registering with the SEC can be completed within 45 days. Rather, much of the work — mostly in the area of developing or confirming internal compliance procedures — must be done by the firm over weeks or months ahead of filing Form ADV and triggering the start of that waiting period, particularly as that period is often far shorter than 45 days.

Form ADV is split into two parts: a primarily check-the-box Part I and a narrative Part II. Part I is filed, via the electronic Investment Adviser Registration Depository (IARD) system, with the SEC as part of the application process. Once filed, it is publicly available at www.adviserinfo.sec.gov and must be updated annually (and at other times to reflect any material changes that have occurred). Part II, which forms the core disclosure document that a registered adviser must provide to its clients, does not currently need to be filed as part of the application. The IARD system does, however, allow an investment adviser to upload Part II (which would then be publicly available) if it wishes to do so. It also appears likely that investment advisers will, in the future, be required to make Part II of the Form ADV publicly available, as has been proposed by the SEC on two occasions in the past ten years.

To be clear, it is the investment adviser business that is required to register with the SEC, not the individuals who work for that investment adviser. However, individuals who are affiliated with a registered adviser, and are 'investment adviser representatives' (generally those engaged in marketing, advising, managing or supervisory activities), may have registration obligations with relevant US state regulators. Some states also provide for testing or other substantive qualification requirements for these individuals. The approach taken in the UK is similar, with registration of the firm and separate examination requirements for key individuals.

Compliance policies and procedures and SEC examinations

The SEC has the authority to conduct examinations of all of the activities and books and records of a registered adviser. During an examination, the SEC staff will be on site at the investment adviser's offices and typically reviews, among other things, the adviser's compliance programme and the adviser's advertising and sales practices. An SEC examination is conducted with relatively short notice (no notice is required) and can last from a week or two to several months. Under a 'follow the money' philosophy, the largest managers measured by assets under management receive the most frequent examinations. But given significant administrative resource constraints, large numbers of managers go years between examinations.

A critical component of any SEC examination is review of the firm's internal compliance policies and procedures. Beginning in 2004, the SEC began a programme in which it requires all registered investment advisers to maintain detailed written procedures and to designate an appropriately senior officer as a chief compliance officer. Failure to have a sufficiently robust internal programme is now a violation of law in and of itself, even absent other issues at a firm.

Capital requirements

There are no capital requirements for registered advisers, although the SEC can (but apparently rarely does) consider the financial soundness of the adviser when deciding whether to approve an application for registration. (Financial troubles at an advisory firm may, however, require disclosure to the firm's clients). This is a significantly different approach from EU models, where capital requirements have been, and under proposed new legislation will continue to be, one of the cornerstones of registration.

Custody

A registered adviser or a 'related person'[3] of a registered adviser that holds, directly or indirectly, client funds or securities, or has authority to obtain possession of them, is deemed to have custody over those funds or securities under the Advisers Act. Fund managers, because of the degree of control over the funds they sponsor, tend to be deemed to have custody over a fund's assets.

The Advisers Act generally requires that a registered adviser with custody of client assets maintain those assets with a 'qualified custodian' such as a bank, registered broker-dealer, or foreign financial institution that customarily holds assets for their clients and segregates those assets from their own assets. A registered adviser itself or its related person may therefore be a qualified custodian. Prompted by the Madoff experience, recent changes to the Advisers Act custody rules impose additional requirements on registered advisers with custody of client assets, including a surprise annual securities count (subject to certain exceptions), an annual internal control report (for instances of true 'self-custody', but not 'deemed custody'), and specific guidelines with respect to the provision of account statements to clients.[4] The most significant exception from the surprise annual securities count, and for account statement requirements as well, is that for private funds whose accounts are audited each year.

Record-keeping

The SEC has signalled that the record-keeping requirements of the Advisers Act are under review and may be replaced by a broader 'business as such' requirement under which essentially all business-related records are maintained. At present, however, registered advisers are subject to detailed rules setting out the types of books and records that are required to be maintained, the duration for which they should be maintained, and (particularly in relation to records held electronically) the manner in which they should be maintained.

Current regulation of private fund managers in the UK

No European regime … currently

There is no pan-European regulation of private fund managers. As discussed in Part 2 below, that is almost certain to change but, nevertheless, the regulation of private fund managers in Europe is currently fragmented. Regulation partly comes in the form of European law and partly in the form of national rules, which vary from country to country. This section describes the position in the UK, where a majority of European hedge fund managers are located, and where fund managers are required to be registered with the FSA. There is no *de minimis* exception, nor any exemption equivalent to the current 'private adviser' exemption from registration as an investment adviser in the USA. Put simply, any firm that manages a fund from the UK will be subject to registration and regulation in the UK.

Registration with the FSA

An application for registration with the FSA is effected by the preparation and filing of an Application for Part IV Permission (so named after Part IV of the United Kingdom Financial Services and Markets Act 2000, as amended). Once an application has been submitted, together with the required fee, the FSA is obliged to approve or reject the application within six months (extendable to 12 months if the FSA considers the original application 'incomplete').

In practice, however, a straightforward application is often approved in as little as two to four months from the date of submission. Nevertheless, this is significantly longer than the time it takes the SEC to process an application for registration in the USA.

A Part IV application requires a significant number of different forms to be completed and financial and other data to be compiled. Unlike a Form ADV in the USA, no part of the Part IV application is publicly available. That said, once regulated by the FSA, a fund manager's core details — including the name, address, permissions granted by the FSA and details of the individuals approved for that fund manager — are a matter of public record and may be viewed by any person by accessing the FSA's website at www.fsa.gov.uk.

As in the USA, it is the fund manager that is the registered (and regulated) entity in the UK. However, many of the manager's principals and employees will need to be approved by the FSA before they are permitted to conduct any activities on behalf of the fund manager. Depending on the activities performed by an individual, examinations may need to be passed before the individual can perform those activities (fund management activities do require examinations).

Compliance policies and procedures and FSA inspections and approach to supervision

In recent years, the FSA has taken a 'risk-based approach' to supervision. Essentially, each regulated firm (including any fund manager) was labelled by the FSA as a high, a medium or a low 'impact' firm. A high impact firm could expect a close and continuous relationship with a named individual at the FSA. At the other end of the spectrum, a low impact firm would probably hear very little from the FSA. This risk-based approach also meant few on-site inspections for many managers unless and until, as Hector Sants, Chief Executive of the FSA recently put it, 'there was clear evidence that something had gone wrong'.[5]

But the days of that light-touch regulation for smaller firms are numbered. The FSA has recently announced its intention to drop the current approach entirely, become more pro-active and adopt a new 'outcomes-based' approach. The changes apparently will involve intervening more frequently and in anticipation of problems arising, rather than in response to problems that have occurred.

As in the USA, UK managers must maintain detailed internal policies and procedures intended to prevent conduct failures by the firm and its personnel. With the changes in approach just outlined, managers now expect more FSA reviews of their systems and controls as well as, potentially, more FSA on-site visits.

Capital requirements

Unlike in the USA, every regulated fund manager in the UK must have a certain level of initial and ongoing liquid capital resources. The rules relating to capital requirements are notoriously complex. The precise amount required for a particular manager will depend on various factors such as the activities performed, annual overhead and perceived risk factors, but the figure frequently runs into several hundred thousands of pounds.

Custody

In the UK, providing custody — or 'safeguarding and administering of assets', as it is called for UK regulatory purposes — is regulated by the FSA and involves both the actual holding of assets and the administration of those assets. Each of those functions needs to be performed in order to fall within the activity. A prime broker will thus be regulated as a custodian in the UK, while a private fund manager often will not be a custodian for UK purposes.

Usually, an FSA-regulated custodian will be required under FSA rules to segregate from its own money and assets any money and assets belonging to a client. However, those rules requiring segregation do not apply where the client transfers full ownership of the cash and assets to the custodian. That is important because many prime brokerage agreements provide for full title transfer by the fund (the prime broker's client) to the prime broker, as part of the prime broker taking security over the cash and assets. As a result, many funds' assets do not benefit from FSA rules requiring segregation.

Post-Lehman, however, many private funds and their managers have been increasingly keen in their prime brokerage agreements to:

- secure segregation for their cash and assets in prime brokerage agreements; and
- limit the amount that a prime broker can re-use (or 're-hypothecate') the fund's assets.

Unlike in the USA, there is no limit in the UK to the value of client assets that can be re-hypothecated by a prime broker.

Record-keeping

As in the USA, private fund managers regulated in the UK are subject to detailed record-keeping requirements, both as regards the types of records that must be kept by the firm and the length of time for which they must be retained. UK firms are also subject to a general obligation to ensure that sufficient records are kept to enable the FSA to ensure that the firm is complying with its regulatory obligations. Put another way, while compliance with the detailed requirements is necessary, it will not always be sufficient.

PART 2 — US DEVELOPMENTS

Registration of investment advisers in the US: the House Bill and the Senate Bill

Each of the US House of Representatives (the 'House') and the US Senate has proposed broad financial reform legislation in response to the recent economic crisis. In the case of the House, that legislation takes the form of The Wall Street Reform and Consumer Protection Act (the 'House Bill'), passed by the House in December 2009 and then again in June 2010. Parallel legislation was adopted by the Senate in May 2010, with the name The Restoring American Financial Stability Act of 2010 (the 'Senate Bill').

The Senate Bill will need to be reconciled with the House Bill (through negotiation between the two bodies) before a final, joint bill is signed into law by President Obama — which could happen as early as mid-July 2010. As this paper goes to press, it appears that a final, joint bill has been largely agreed, which will be named the Dodd-Frank Bill after its sponsors.

The House Bill and the Senate Bill both propose wide-reaching and significant changes to the financial markets and supervision of those markets. But it is their approaches to fund manager regulation, which will now be considered.

Broadened registration requirements for investment advisers

Title IV of the Dodd-Frank Bill is the proposed Private Fund Investment Advisers Registration Act of 2010, which is referred to in this paper as the 'Fund Manager Registration Act'.

The Fund Manager Registration Act envisages direct oversight by the SEC over a swath of the asset management industry whose members have long been able to structure their businesses to avoid SEC registration. Background materials to the proposals in both the House and the Senate refer to this broadened registration as embodying such politically appealing ideas as 'transparency' and 'accountability' (with more reporting) and 'levelling the playing field' (between regulated and unregulated businesses).

The legislation would achieve these goals primarily by eliminating the private adviser exemption referred to in Part 1 above. As a result, absent availability of one of the new, more limited exemptions now under consideration, all private fund managers with at least US$100m (or, in some cases, US$150m) of assets under management will need to register with the SEC. Upon registration, managers will become subject to the full panoply of the requirements of the Advisers Act and its regulations, including requirements as to advisory contracts and advisory fees, disclosure to clients and regulators, advertising, use of solicitors and placement agents, written compliance programmes, code of ethics practices, the appointment of a qualified chief compliance officer, and SEC inspections.

While many of the largest private fund managers are already registered under the Advisers Act, this new registration requirement will represent a fundamental change for many others, who will lose the option to operate outside this regulatory regime. Especially for smaller managers, the incrementally increased costs of doing business that registration and regulation will bring will be an issue.

Foreign private adviser exemption

A version of the old private adviser exemption would be retained, but solely for the benefit of non-US investment advisers. A non-US adviser looking to this exemption must:

- have no place of business in the USA (current exemptions for non-US advisers allow somewhat more US contacts than this 'no place of business' standard);
- have 14 or fewer US clients and US investors in its private funds;
- have less than US$25m in assets under management attributable to US clients and US investors in its private funds;
- not hold itself out generally in the USA as an investment adviser; and
- not advise a US-registered investment company or business development company.

Venture capital (but not private equity) and family office exemptions

Managers of venture capital funds would benefit from a special exemption from registration under the Fund Manager Registration Act, although venture capital fund managers would still be expected to comply with certain reporting requirements. 'Family offices' investing family money likewise would not have to register. Under the Senate Bill (but not the House Bill), private equity fund managers had been proposed for an exemption, but that will not be the case. Under the final Dodd-Frank Bill, those managers will be subject to the same requirements as fund managers more generally. What constitutes a 'venture capital fund' and 'family office' would be left to the SEC to determine in due course.

SEC interpretive authority

Aspects of the Fund Manager Registration Act can be read to give the SEC greater authority to define terms used in the Advisers Act. Depending on the circumstances, that fairly innocuous sounding authority can carry great significance. By way of illustration, narrowly drawn interpretive authority (at least in the eyes of the courts) led to two recent courtroom defeats in which it was determined that the SEC had overstepped its regulatory authority as to who is or is not required to register under the Advisers Act. The most famous of those two defeats, and certainly the most relevant to the facts at hand, was *Goldstein v. SEC,* which overturned an earlier SEC effort to register hedge fund managers.[6]

That said, the SEC is to be prohibited from defining the term 'client' to include an investor in a private fund, at least for purposes of Sections 206(1) and (2) of the Advisers Act (both are broad, antifraud provisions). This limitation on the scope of how a client might be defined is significant because the Advisers Act imposes a variety of antifraud and fiduciary duties on investment advisers with respect to their 'clients' which, for the most part, include funds and exclude fund investors under current law. As a fund's investors can have conflicting interests with each other, it is often not practicable to comply with a fiduciary duty to each particular fund investor.

New reporting requirements for registered investment advisers

The Fund Manager Registration Act would authorise the SEC to require a registered adviser to maintain records regarding the private funds it advises and submit reports to the SEC. As now proposed, those records and reports will need to detail the amount of assets under management, use of leverage, counterparty credit risk exposure, trading and investment positions, valuation policies and practices of the fund, types of assets held, side letters, and trading practices. But the SEC would also be empowered to require records and reporting on other topics 'as necessary or appropriate in the public interest and for the protection of investors'.

The Fund Manager Registration Act provides that proprietary information contained in reports filed with the SEC will be treated confidentially. Nonetheless, this proposal probably signals the end of the era in which those operating in the private fund industry could count on opacity as an industry norm.

Volcker Rule

On 21st January, 2010 — more than a month after passage of the House Bill — President Obama called for new restrictions on certain proprietary trading activities and the size of US banking groups (including the US operations of non-US banks with a US banking office).[7] These restrictions — popularly referred to as the 'Volcker Rule' — were then reflected in the Senate Bill.

Under the Dodd-Frank Bill, US banks, as well as any of their affiliates, will largely be prohibited from, among other things, 'sponsoring and investing in' a hedge or private equity fund. A bank or bank affiliate will be 'sponsoring' a fund if it acts as general partner of the fund, it controls a majority of the fund's board, or the fund and the bank share the same name (or a variation of the same name). Importantly, the Volcker Rule will *not* prevent any entities within a banking group from acting as manager of an independent fund, provided that no entity within the banking group also provides credit to, buys assets from, issues a guarantee on behalf of, or enters into certain other similar transactions with that fund, unless special regulatory approval is granted.

In general, investments by a US bank or bank affiliate in a hedge or private equity fund will be prohibited. A carve out from the prohibitions on fund investments (and sponsorship) would exist in certain circumstances where the banking group organises and offers a fund in connection with its fiduciary advisory services provided to customers and the fund is open to recipients of those services. Outside 'de minimis' co-investments in these funds established for bank customers, the Dodd-Frank Bill would appear to prevent a manager that is covered by the Volcker Rule from aligning its interests with other investors by taking an equity stake in the managed fund.

Under the Dodd-Frank Bill, the US federal financial agencies would have the authority to interpret the scope of an exemption permitting non-US headquartered banking groups to conduct otherwise impermissible fund-related activities to the extent the activities are conducted solely outside the USA. The Dodd-Frank Bill, however, does not clarify whether non-US banking groups may rely on this exemption to sponsor a hedge or private equity fund if the fund is open for sale or sold to US residents.

Systemic risk regulation

Other provisions of the Dodd-Frank Bill, while largely described in the media as focused on banks, create a new 'systemic risk regulator' with broad authority to identify market participants that pose systemic risks. In particular, the new systemic risk regulator is proposed to have the authority to decide that a non-bank financial company poses a threat to financial stability and should be subject to supervision by the Federal Reserve. In reaching such a decision, the systemic risk regulator will consider factors such as the degree of leverage employed by the company, the nature of its financial assets, its funding sources, its links with other institutions and its importance as a source of credit and liquidity to the US financial system.

Under that framework, it is possible that a private fund could be determined to be a non-bank financial company that posed a threat to financial stability. Such an outcome potentially would see the private fund treated like a systemically important bank, thereby subject to heightened prudential standards, possibly including capital and liquidity requirements, leverage limits and enhanced public disclosures.

Regulation of private funds as major swap participants

Other provisions of the Dodd-Frank Bill could see some private funds subject to direct regulation by virtue of engaging in derivatives transactions. Any 'major swap participant' would be required to register with and be subject to regulation by the SEC and/or the Commodity Futures Trading Commission (CFTC). Registration in this case will bring with it minimum capital and margin requirements, increased reporting, record-keeping and business conduct rules, a requirement to segregate margin from other assets and, potentially, limits on particular types of derivative positions that may be taken by the major swap participant.

'Major swap participant' is defined in the Dodd-Frank Bill as a person who is not a swap dealer and who either (i) maintains a substantial position in swaps in any of the major swap categories, excluding positions held for hedging or mitigating commercial risk and certain hedging positions maintained by employee benefit plans, or (ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets, or (iii) is a 'financial entity' that is highly leveraged and maintains a substantial position in outstanding swaps in any of the major swap categories. Many aspects of this definition are to be elaborated upon by CFTC and/or SEC regulation.

The Dodd-Frank Bill defines the term 'financial entity' to expressly include private funds. So, while private funds might have expected not to be primary targets of the proposals to regulate major swap participants, certain leveraged private funds that routinely engage in derivatives trading are apparently intended to be captured.

PART 3 — EUROPEAN DEVELOPMENTS

The proposed Alternative Investment Fund Managers Directive

The original draft of the proposed Alternative Investment Fund Managers Directive (the 'AIFM Directive') was published by the EU Commission (the 'Commission') in April 2009. The primary aim of the AIFM Directive is to establish, for the first time, pan-European regulation of EU-domiciled managers of alternative investment funds (being any funds other than EU-regulated retail funds and so basically the same types of vehicles referred to throughout this paper as private funds). The initial draft of the AIFM Directive was deficient in numerous ways;[8] industry response to the draft was overwhelmingly critical; and it was subsequently admitted that the Commission had produced the draft under significant time and political pressures.[9] Rather than being scrapped entirely after that inauspicious start, the draft AIFM Directive has instead undergone a number of comprehensive rewrites over the past 12 months.

Should it continue forward as expected, the AIFM Directive will be adopted under the EU's 'co-decision procedure'. In theory and in its simplest form, the procedure involves three broad steps:

1. The Commission proposes legislation.
2. Each of the EU Council of Ministers (the 'Council') and the EU Parliament (the 'Parliament') review the Commission's original draft, prepare and debate their own amendments, and then produce their own suggested version of the legislation.
3. The Council and the Parliament conform their own versions into one agreed text, which is then approved by each body.

Stage 2 (the process of amending the initial draft) took over a year, with the Parliament and the Council finally adopting their own versions on 17th May, 2010 and 18th May, 2010 respectively. At the time of writing, the Parliament and Council are engaged in Stage 3 (the conforming of versions), with a view to agreeing a final text by July 2010. Despite that tight timeframe, there are considerable differences between the two versions. In many cases, those differences are not just technical: they reveal fundamental disagreements on points of principle. Even at this late stage, then, it is difficult to predict what the final text of the AIFM Directive will look like, but there are certain clues in the versions adopted by each of the Council and the Parliament.

All fund managers located in the EU must be authorised and duly capitalised

This will capture any person that provides 'investment management services' (ie, portfolio management and risk management) to one or more funds. Under the Council's version, smaller fund managers (those with no more than €100m of assets under management or, in the case of private equity fund managers, with no more than €500m of assets under management) may benefit from an exemption from the AIFM Directive if individual Member States permit. The Parliament, though, favours there being no *de minimis* exemption at all: in which case, all fund managers in the EU, regardless of size, would be compelled to register and be authorised under the AIFM Directive.

Either way, most EU managers are already regulated, so this will make few waves. However, authorisation under the AIFM Directive requires capitalisation of the fund manager — a new requirement in some jurisdictions (although not the UK). Each manager will be required to be capitalised to a minimum of €125,000 plus an amount equal to 0.02 per cent of assets under management exceeding €250m. By way of illustration, under this test a manager with €1bn under management, would need to maintain €275,000 in capital. It is possible that a smaller capital requirement will apply to managers of unleveraged private equity funds.

It is important to emphasise that the AIFM Directive only requires the authorisation of fund managers established in the EU. Managers located outside of the EU will not be required to be authorised. Parts of the AIFM Directive will, however, affect non-EU managers, particularly by restricting the ability of those managers to market their funds to EU investors (discussed below).

Timing of authorisation

An EU regulator will have six months (on the Council's version) or three months (on the Parliament's version) to determine whether to accept or reject an application for authorisation. Whatever timeframe is finally agreed upon, it seems clear that an application will take much longer to be determined in the EU than is currently the case in the USA (where the SEC is required to process an application within 45 days, as discussed above).

Marketing

Once authorised, EU managers will be able to market EU funds to professional investors across Europe on the basis of a 'passport'. This is a significant 'plus' of the AIFM Directive. At present, there is no harmonised regime for marketing alternative funds across the EU and rules relating to the marketing of funds vary considerably from country to country. As a result, marketing a fund across Europe can be an expensive and painful process. Under the AIFM Directive, a simple filing and notification procedure should enable an EU manager to market an EU fund to investors across Europe without hindrance.

However, the extent to which the AIFM Directive will allow either EU managers to market non-EU funds into Europe or non-EU managers to market any funds at all into Europe remains to be seen. This is perhaps the most significant issue highlighted in a number of letters sent to EU policymakers by US Treasury Secretary Timothy Geithner (discussed below).

After significant industry pressure, both the Council's and the Parliment's versions suggest that marketing that responds to initiative taken by the prospective investor (so-called 'reverse solicitation') will fall outside the scope of the AIFM Directive and will be permitted. This would allow investors to actively seek out the funds and managers they want, regardless of where those funds or managers are located. For non-EU funds, through this apparent ability for investors to seek out their funds may ultimately be of little use. As discussed below, the Parliament is seeking to introduce a complete ban on investments in non-EU funds by EU investors, unless those non-EU funds meet certain detailed — and some would say unrealistic — requirements.

Use of custodians

Every EU-authorised manager will be obliged to appoint a custodian (called a depositary under the AIFM Directive) to hold the assets of a fund managed by that manager. One of the key outstanding questions is whether or not that custodian will need to be located in the EU, as seems likely for the majority of funds, or could instead be a custodian located outside the EU. This is another of the significant issues highlighted by Treasury Secretary Geithner's letter.

A requirement to use an EU custodian has obvious political appeal, but also presents serious practical issues. Especially for certain types of assets, the pool of eligible EU custodians may be thin or non-existent. Similarly, to the extent that an acknowledged leader in a particular custody segment happens to be ineligible solely as a matter of geographic location, managers (and ultimately fund investors) would suffer from placing that custodian arbitrarily off limits.

Disclosure and reporting obligations

All EU-authorised fund managers will be subject to detailed disclosure and reporting obligations. Managers engaging in leverage, and private equity fund managers, will be subject to additional obligations.

Remuneration

The original draft of the AIFM Directive contained nothing on remuneration of a fund manager's staff. Yet, while the Council and the Parliament were in the process of creating their own revised drafts of the AIFM Directive, the G20 issued a communiqué endorsing the Financial Stability Board Principles for Sound Compensation Practices, and suggesting that compensation should be aligned with 'long-term performance', rather than excessive risk-taking.[10]

Proposed rules relating to compensation of a fund manager's staff were swiftly incorporated by each of the Council and the Parliament into their versions of the AIFM Directive. As with many other areas, there are differences between the Council and the Parliament's approach to remuneration. However, the AIFM Directive in its final form is likely to require a fund manager to establish and apply a remuneration policy that does not unduly encourage risk-taking. In addition, a 'substantial portion' (which could be as much as 50–60 per cent) of bonuses should be deferred for an appropriate period, and that, except for new staff in the first year of their employment, guaranteed bonuses would not be permitted at all. If implemented, this approach would represent a dramatic divergence from regulation in the USA, where — except for fund managers housed within banks, whose staff would be subject to bank-wide compensation rules — there is no corresponding proposal to regulate compensation.

Significant issues of the AIFM

Perhaps more than any other aspect of the draft AIFM Directive, its treatment in various ways of non-EU countries has attracted the most attention and polarised opinion. The issues that particularly ignited debate relate to proposed marketing rules that discriminate geographically and the ability of EU fund managers to use non-EU service providers.

EU managers marketing Non-EU funds

Under the Parliament's version of the AIFM Directive (but not the Council's), it is theoretically possible that non-EU funds could benefit from the 'passport' given to EU funds, discussed above. In order to do so, though, numerous 'cooperation' agreements and other arrangements would need to be in place between regulators in that Member State and in the non-EU country where the fund is established. The Commission would have the power to determine which non-EU countries meet these requirements. There are concerns that overtly political considerations will be inserted into the process of judging cooperation arrangements, with the result that some countries will be favoured over others for reasons not strictly relating to the strength of their regulatory infrastructures.

The Parliament's version is somewhat 'all or nothing' since, if a non-EU fund does not meet all of the requirements, not only could the fund not be marketed, but EU investors would be banned from investing in that fund, as discussed below.

The Council is more pragmatic. It prefers an approach that would give individual countries the discretion to allow marketing to professional investors on their territories. Arrangements would still need to be in place between EU and non-EU regulators, but they are fewer — and some observers might say 'more realistic' — than those contained in the Parliament's version.

Non-EU managers marketing EU or non-EU funds

If the final version of the AIFM Directive takes the same approach as the Council's draft then non-EU managers will, if they want to market their private funds into Europe, be required to comply with significant reporting and disclosure requirements. What those requirements look like will be left for future rules to be made by the Commission. On the face of it, although, the rules could include:

1. filing an annual financial report with regulators in each Member State in which the manager conducts marketing activities;
2. making initial and ongoing disclosures to investors in relation to the operation of the relevant funds; and
3. in the case of any fund that takes a controlling stake in EU companies,[11] making additional disclosures to those companies, its shareholders, employee representatives and regulators.

Again, under the Council's draft, before any marketing in a Member State was permitted, 'appropriate cooperation arrangements' would need to be in place between regulators in the home jurisdiction of the fund manager and the Member State being targeted for marketing.

The Parliament takes a fundamentally different approach. It would require non-EU managers to comply with the entire AIFM Directive. What is really groundbreaking, though, is a requirement that the AIFM Directive seeks to place upon non-EU regulators. In order for a non-EU manager to market its private funds into Europe, the non-EU regulator must agree to effectively act as agent of the European Securities and Markets Authority (ESMA) — the new European regulator — in enforcing the terms of the AIFM Directive against the non-EU manager. The idea that regulators such as the SEC might agree to perform this role (and do so on a timetable that will offer a measure of relief here) is sufficiently new that it has, apparently, been described by some in the industry as 'barking' mad.[12] On the other hand, regulators in fund domiciles whose national economies depend on a vibrant funds business (with the Cayman Islands as an obvious example) likely would come around quite quickly.

Non-EU funds generally — the Parliament's thunderbolt

A new provision contained in the Parliament's adopted version of the AIFM

Directive — but not the Council's version — would draw a line in the sand between the treatment of non-EU funds and EU funds. Quite simply, if a non-EU fund did not meet the requirements of the AIFM Directive discussed above, any investment in a non-EU fund by an EU-based professional investor would be prohibited. This would apply even for investments made at the initiative of the investor, and regardless of whether the manager himself was based in the EU or elsewhere. It is not clear whether existing investors in such funds would be expected to liquidate their investment, which could be very difficult (or even impossible) for investors in some funds, such as real estate or private equity funds in particular. This latest 'thunderbolt' from the Parliament could, if adopted in the final text, potentially see some countries disappear as potential domiciles for private funds, to the extent that EU investors are to be targeted by those funds.

Non-EU service providers

As noted above, the issue of whether the AIFM Directive will limit the use of custodians to those in the EU is controversial, but not yet resolved. In addition to the serious practical issues presented, rulemaking that favours EU custodians ultimately could represent the first steps on a slippery slope. There are strains of thought among those involved in crafting the proposal that would emphasise EU service providers generally.

Geithner, Osborne and a 'still much to play for'

In a leaked letter dated 1st March, 2010 from US Treasury Secretary Timothy Geithner to Michel Barnier, European Commissioner for the Internal Market (the section of the EU Commission responsible for the AIFM Directive),[13] Geithner stated that the Treasury Department:

> 'was concerned with various proposals that would discriminate against US firms and deny them the access to the European Union market that they currently have…'

adding that:

> '[the Treasury Department] hope[s] 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 EU counterparts. You will see that our approach in the United States maintains full access for EU fund managers and custodians to our market.'

There then followed several other (leaked) letters sent by Geithner to individual EU finance ministers, in which Geithner emphasised similar points.[14] It was also reported on 24th March, 2010 that US Senator Charles Schumer (D — NY) had contacted Geithner, urging the latter to ensure that the final version of the AIFM Directive did not 'discriminate' against US firms.[15] EU policymakers will have been chilled by Senator Schumer's suggestion that, if the EU ignored US concerns and adopted a 'protectionist' AIFM Directive, the USA consider introducing 'tit-for-tat' legislation designed to limit access by EU fund managers to the rich US market.

Pressure from the EU looks unlikely to abate between now and the eventual adoption of the final version of the AIFM Directive. Others in government have also expressed hope that the private funds industry may yet get a better result than expected. George Osborne, newly-appointed UK Chancellor, was reported to be relatively upbeat, suggesting that there was 'still much to play for'.[16] This presumably reflects Osborne's belief that he has an acknowledgment by the Council that the UK's concerns — particularly relating to the treatment of non-EU funds and non-

EU managers — would be taken into account by the Council when negotiating a final text with the Parliament.[17]

CONCLUSION

Currently, registration with the SEC as an investment adviser and authorisation in the UK have clear similarities, but the two frameworks are fundamentally different in some key respects. First, SEC registration is, for many managers, voluntary, while a far more broadly applicable regime reigns in the UK. Secondly, as a rule of thumb, relative to authorisation in the UK, registration in the USA is also generally quicker, cheaper and involves less detailed analysis of the prospective investment adviser.

Representing a kind of return to the mean, all of those distinctions are being blurred as a result of proposed changes to US, UK and EU laws and regulations. In the USA, the widely relied upon private adviser exemption is likely to be swept away, while in the EU, the proposed AIFM Directive aims to introduce a pan-European authorisation regime for all EU private fund managers. Likewise, both in the USA and Europe, substantive regulation of fund managers — ie, regulation of business practices, notably custody and reporting, that goes beyond a simple registration regime — is on the rise.

And the global reach of these pieces of legislation should not be forgotten. Once the AIFM Directive (in the EU) and the Fund Manager Registration Act (in the USA) are implemented, an EU-domiciled fund manager could find itself subject to both authorisation in the EU and registration in the USA. At the same time, a US-domiciled investment adviser could find itself subject to registration in the USA, while also being required to comply with some or all of the AIFM Directive's record-keeping and disclosure obligations in order to market to investors located in the EU — if they are permitted to do so at all. As a final observation, with US regulatory outcomes increasingly settled, the big remaining regulatory questions for the global private funds industry appear to be in European hands for the moment.

References

(1) This paper focuses on the regulation of private fund managers. For an overview of other important regulatory reform proposals across the USA and the EU, see 'Global Financial Regulatory Reform Proposals: An Overview', available at: http://www.shearman.com/Publications/detail.aspx?publication=6f637035-1787-4bec-98f1-1cf35f8ad2d1.

(2) See Section 202(a)(11) of the Advisers Act.

(3) Under Advisers Act Rule 206(4)-2(d)(7), a 'related person' includes anyone who controls, is controlled by, or is under common control with the adviser.

(4) See 'SEC Amends Investment Adviser Custody Rules', available at http://www.shearman.com/SEC-Amends-Investment-Adviser-Custody-Rules-01-07-2010/.

(5) Speech entitled 'UK Financial Regulation: After the Crisis', given by Hector Sants, Chief Executive of the FSA on 12th March, 2010. Text available at: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/0312_hs.shtml.

(6) *Goldstein v. SEC,* 451 F.3d 873 (D.C. Cir. 2006).

(7) For an in-depth discussion of the Volcker Rule (as well as arguments in favour of and against the Volcker Rule), see 'Understanding the Significance of the Obama Administration's Proposed "Volcker Rules"', available at: http://www.shearman.com/understanding-the-significance-of-the-obama-administrations-proposed-volcker-rules-02-17-2010/.

(8) For more detail on the original draft proposed AIFM Directive, see 'Updated: New European Proposals for the Regulation of Alternative Investment Fund Managers', available at: http://www.shearman.com/fia-050509-updated-new-european-proposals-for-the-regulation-of-alternative-investment-fund-managers/. For a comparison of revised drafts prepared by the Council and the Parliament, see 'Update on the Proposed European AIFM Directive: Council and Parliament Publish Draft Amendments', available at: http://www.shearman.com/update-on-the-proposed-european-aifm-directive-council-and-parliament-publish-draft-amendments-12-08-2009/.

(9) Per David Wright, the Deputy Director General of the EU Commission, speaking at the FSA's annual Asset Management conference on 17th September, 2009.

(10) At the date of writing, the G20 communiqué is available at: http://www.pittsburgsummit.gov/media center/129639.htm.

(11) According to the Council's latest draft, a controlling stake for this purpose is more than 50 per cent of voting rights in the company. The original draft of the Directive set the threshold at 30 per cent.

(12) See 'AIFM Directive endgame: But three-way talks must overcome wide divergences', available at: http://www.complinet.com/global/new s/news/article.html?ref=132201.

(13) At the date of writing, a copy of the letter may be found at: http://ftalphaville.ft.com/blog/2010/03/11/172951/revealed-the-geithner-letter-to-eus-michael-barnier/.

(14) At the time of writing, a copy of one such letter sent to Alistair Darling — then the UK Chancellor—may be found at: http://media.ft.com/cms/c562f8a4-41bd-11df-865a-00144 feabdc0.pdf.

(15) See 'Senator says US may hit back over EU fund rules', at the date of writing available at: http://www.reuters.com/article/idUSN2416508720100324.

(16) See 'EU approves hedge fund proposal', available at: http://www.european voice.com/article/2010/05/eu-approves-hedge-fund-proposal/67989.aspx.

(17) *Ibid*.