

FUNDS

The impact of the proposed Directive on alternative investment fund managers

BY PAULINE RENAUD



On 30 April this year, the European Commission (EC) released its draft Directive on Alternative Investment Fund Managers (AIFM). The Directive aims to provide a regulatory and supervisory framework for managers of hedge funds, private equity firms and other alternative investment vehicles in order to improve transparency and create more certainty for investors and public authorities. Indeed, the draft Directive stems directly from concerns about the adequacy of the regulatory framework for the European Union's financial markets, which was clearly rocked in the wake of the financial crisis and by several subsequent scandals, notably the Madoff case. But the Directive has provoked intense criticism from private equity and hedge fund players, who fear that it could severely damage their ability to compete with other investment managers. "The main argument developed by the hedge fund industry is not that there is too much regulation. Actually, the industry welcomes good regulation – the problem is that the directive has been poorly drafted, in great haste and with little consultation," says Andrew Baker, chief executive officer of the Alternative Investment

Management Association (AIMA). It is also believed that the legislation is aimed at reducing the influence of London, currently the leading financial centre in Europe. As a result, many are calling for several key points to be modified. However, some industry experts have also praised the fact that the draft Directive addresses some major, long-standing issues.

A common approach within the EU

The AIFM Directive aims to introduce a uniform framework across the EU for the regulation of alternative investment fund managers, the marketing of alternative investment funds, and the provision of services to alternative investment funds by third parties. More specifically, it applies to managers of any collective investment undertaking, or alternative investment fund (AIF), other than those covered by the UCITS Directive. "The only entity in the EU permitted to manage and administer an AIF is a manager whose head office is in an EU Member State and who is authorised under the Directive," explains Sam Kay, a partner at Travers Smith LLP. "There are a number of exemptions, for example for EU banks and EU insurance companies. Sovereign wealth

funds are also outside the net of the Directive," he adds. The definition also excludes single investor mandates, such as managed accounts, and other non-collective investment undertaking structures. The scope of managers concerned by the Directive is, nonetheless, very wide.

But some professionals are unhappy that it does not differentiate between different types of fund, notably their managers and alternative investment strategies. Indeed, the legislation proposes the same requirements, concerning minimum capital, disclosure, independent valuations, transparency, as well as depository or custody functions for all types of funds – regardless of the type of fund. "The disclosure requirements cover disclosure of certain information about the fund and its assets to investors, regulatory authorities and shareholders of portfolio companies and employees. Moreover, it foresees each manager shall be required to ensure that for each AIF a depository, which must be a credit institution, is actually appointed," explains Patricia Volhard, a partner at P+P Pöllath + Partners. She adds that the depository's function is to safe-keep financial instruments, receive payments, and verify the transfer of ownership of the acquired assets. This depository is also liable to the AIFM and its investor for any losses suffered as a result of failure to perform its obligations. In addition, the draft also asks for the appointment of an independent valuator. Concerning capital requirements, the Directive will ask most managers to hold capital equal to the value of their firm's annual expenses, with €125,000 as a minimum threshold. In addition, they must calculate the total value of their portfolio companies under management, subtract €250m, and put aside a further 0.02 percent of this difference in value.

The draft only allows AIFMs to market in the EU AIFs domiciled in a 'third country' from 2014, or three years after the Directive becomes law in Europe. This is intended to allow the Commission time to check whether

the regulatory framework and supervisory arrangements in those countries match up to the Directive. In the meantime, member states may allow or continue to allow AIFM to market AIF domiciled in third countries to professional investors on their territory, subject to national law. "Requirements in relation to 'third countries' restrict both fund managers located in third countries operating in the EU, and EU-based managers managing funds in third countries," confirms Javier Echarri, secretary general at EVCA. There are some concerns that European investors will not be able to invest outside of Europe, and that this may hit institutional investors, such as pension funds.

Experts explain that to allow third country AIFM or AIFs to market in the EU, the Directive will require a certain level of cooperation between member states and those third countries. For example, a member state will only be able to authorise third country AIFM to market AIF in that member state if, among other things, a cooperation agreement is in place between that member state's regulator and the supervisor of the AIFM. In addition, the country in which the AIFM is established must have signed an agreement with the member state that is consistent with Article 26 of the OECD Model Tax Convention, and the country in which the AIFM is established must provide equivalent market access to European funds. Where the Directive regulates the ability of AIF to outsource, it envisages cooperation agreements between member state and third country regulators – for example, Article 38 (where an AIF's depository is delegating custody functions to a depository located in a non-member state) and Article 36 (where an AIFM is delegating administrative services to an entity located in a non-member-state).

"The draft Directive already provides for interaction between member states in a number of areas," adds Donnacha O'Connor, a partner at Dillon Eustace. "For example, Article 34 of the Directive enables AIFM authorised in one member state to provide management services to AIF domiciled in another member state, either on a freedom of establishment basis, or freedom to provide services basis, provided that the AIFM's home member state authorisation extends to the management of that type of AIF," he says. Once authorised, the AIFM gets a 'passport' (similar to those held by UCITS funds and for certain credit and financial institutions) to market their products to professional investors in all 27 EU member states. However, it should be mentioned that cross-border marketing is subject to the filing of information with the host member state authority. There is also a requirement under Articles 45 to 47 for member states to coop-

erate as regards the exchange of information and as regards the supervision of AIFM. Also, under Article 47, member states have the right in some circumstances to refuse to cooperate with other member states.

Given that marketing within the EU is limited to professional investors, some fear that most high net worth or sophisticated investors will be ruled out of this activity. But Filippo Annunziata, founder of Annunziata e Associati, believes this limitation ought to stimulate the creation of a European market for alternative funds, with a higher level of transparency and controls. "The Directive should, however, be better focused as to its scope; currently, it encompasses a wide range of different products. This may reduce its positive impact and lower its effectiveness in stimulating the integration of the common market," he says. Some experts also believe that funds within the EU will look very similar, as they will be subject to the same type of regulation. But forum shopping and competition between member states is expected, by certain professionals, to continue. Also, those member states which implement the new regulation most efficiently are likely to become the target countries for fund managers.

Impact on fund managers and investors

Of course, the draft Directive not only alters the regulation of the alternative investment market across Europe, but also directly impacts fund managers and investors. Significant requirements are imposed on them, not only in terms of their capital levels and internal organisation, but also with regards to the way they can delegate their activities and the level of responsibility for those delegates, among other criteria. Ultimately, the exact impact on managers will depend on the type of fund managed and on the location. For example, some alternative investment fund managers are already subject to supervision and regulation in certain countries, whereas others are not regulated at all. But most professionals largely agree that the Directive mainly targets hedge funds. "Undoubtedly, the Directive seems to be primarily concerned with hedge funds and similar vehicles, but its scope extends to private equity funds, real estate funds, open end non-UCITS funds, etc.," points out Mr Annunziata. "Fund managers will be subject to stricter requirements than those applicable today in many jurisdictions to non-UCITS fund managers, especially in terms of controls, risk management, transparency and reporting," he says.

In addition, some argue that, for managers working outside the EU, fundraising will be particularly difficult or even impossible, and EU fund managers will have trouble imple-

menting their investment strategy outside of the EU. "As things stand, within three years of adoption, it will be very difficult to sell non-European funds in Europe, particularly unregulated funds, and the Directive will make it difficult and more expensive for non-European managers, administrators and depositaries to service non-UCITS that are sold into Europe," warns Mr O'Connor, adding that the Directive will likely increase the cost of running non-UCITS, which will have an adverse impact on investors. Indeed, some expect that investors will be prejudiced due to the higher fees and less competitive investments. Conversely, others believe that investors will benefit from the stronger controls and close supervision of the alternative funds industry, particularly regarding the increased transparency and disclosure.

Indeed, since the financial crisis broke, investors have increasingly made transparency a priority when considering an investment, which may in turn encourage fund managers to be more compliant with disclosure requirements. "The information AIFMs are required to disclose is not necessarily of a type that would lead to competitiveness concerns and might have the opposite effect given that transparency is generally considered, on the investor side at least, to be a good thing," says Mr O'Connor. Under the proposed Directive, investors must be provided with a description of the fund's objectives and investment strategy, including assets in which the fund may invest, the investment techniques that may be employed, details of the circumstances in which leverage may be used, the types of sources of leverage permitted and any associated risks. Notably, AIFMs must periodically disclose the percentage of their assets subject to special arrangements arising from their illiquid nature. They must also provide an annual report to investors and relevant regulators, containing statements of assets and liabilities, income and expenditure, and a report on activities for the financial year. It must also disclose any preferential treatment it gives to one investor over another. Additional disclosures are required from certain types of AIFM.

But according to Ms Volhard, the disclosure requirements to other shareholders and employees of a portfolio company with respect to 'controlling' investment in portfolio companies distort the playing field in two ways. "Firstly, AIFs are at a disadvantage compared to other private investors making a 'controlling' investment in a portfolio company. Secondly the portfolio company itself will find itself at a competitive disadvantage compared to other portfolio companies which have no AIF investors. Neither systemic risk nor investor protection can justify such difference in treatment," she says, adding that, going forward, ►

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powerful investors may choose to make investments directly themselves, rather than using a pooled vehicle which may be subject to many requirements and therefore higher costs. "Such transparency and disclosure obligations also seem to indicate a huge shift towards the law requiring certain types of shareholders to owe obligations to companies in which they invest," adds Mr Kay. "It is possible that fund managers will respond by restricting their activity within the EU, therefore providing investors with less opportunity to invest and reducing the amount of capital available to the EU market."

There are some concerns over the high level of regulation and control being exerted by governments for sophisticated investors. Indeed, the Directive seems to imply that sophisticated investors need more protection than retail investors, largely due to the fact that they were severely affected by recent scandals, such as Madoff. But some experts warn that a one-size-fits-all protection for investors is not the right solution. "Reasonable regulation and in particular transparency requirements as such can improve the investment environment and motivate investors to make investments via a pooled investment vehicle. However, over-regulation in which investors do not see any benefit will only harm the industry," asserts Ms Volhard. Opponents of this view argue that, given the level of evolution reached by alternative funds, a certain level of regulation and controls is necessary to mitigate risks.

Going forward

Concerning the long-term impact that the

Directive will have on the industry, as well as on managers and investors, the disagreements between both sides have been serious. For his part, Mr Annunziata believes that the new regime will provide a common framework, within which all European funds will fit. "Another significant impact will be on non-EU funds. As long as these are managed by an investment manager who complies with the Directive, they too could benefit from the new regulations and from the potential integration of the EU market for alternative funds," he adds. But some fear that, due to this umbrella regulation, independent fund managers will disappear, along with the healthy competition between funds and fund managers. Those professionals argue that the draft should be corrected to take into consideration the different types of funds and managers, and provide for further exemptions and reliefs in case of little investment or systemic risk. "The Directive should also focus on three key issues: registration and authorisation; reporting of systemically relevant data; and a workable passport," adds Mr Baker. "If it did so, then it would create a progressive framework for the industry within the European Union to address the concerns raised about systemic risk issues," he says.

Like many other experts, Mr Echarri maintains that changes to the draft are essential, as poorly-conceived and rushed regulation will only be harmful for the industry. "If the regulation is not appropriate, it will have a damaging effect on fundraising and investment in the European economy. Meanwhile it will increase costs, lower returns and concentrate

risks in European institutions' investment portfolios, exacerbating Europe's pension crisis." Few indeed believe that the Directive, as it has been drafted, will make the marketing of alternative investment funds more streamlined across the EU. "The more likely scenario is that the protectionist measures will drive people away from investing in Europe and there will be less inward-investment from funds based in countries like the US. EU banks may become more powerful as they will not need to comply with these rules," warns Mr Kay. He also says that sovereign wealth funds may actually become more active in acquiring EU assets, given the fact they will be at a competitive advantage compared to European private equity and real estate funds.

Although the AIFM Directive is only at a very early stage of the legislative process, it has already provoked heated debate within the industry – a sign that alternative investment fund managers and professionals operating in the market are concerned about the potential effects of such large-scale changes. The Commission itself is open in anticipating "intense political discussion and negotiation" of the Directive. Ultimately, the financial crisis has exposed the need to fill gaps and overcome inconsistencies in the current regulatory framework to limit potential risks in the future. But it is also true that hedge funds and private equity played but a limited part in the creation of the current financial turmoil, and onerous regulation may deter future investments within the EU. Whatever form the changes take, most professionals predict a significant shake-up of the industry in the coming years. ■



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