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Alternative Investment Fund Managers to be regulated under European proposals

Background

To date, there has been no direct regulation of investment funds activity in the European arena, other than authorised open-ended funds. Activities are regulated by a combination of national financial and company law regulations and general provisions of community law, complemented in some areas by industry-led standards. Since the emergence of the financial crisis, the regulation of the hedge fund sector in particular, has been in the spotlight and there is now international consensus for regulation.

The present legislative initiative was born out of the Commission's review of the regulatory and supervisory framework for all financial sectors across the EU. This examination was in line with the G20 Leaders' November 2008 pledge "*to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances*". The month following that declaration, the Commission issued a consultation paper on the regulation of hedge funds, which served as the basis for the proposed Directive.

Further discussion to the debate was added by **Jacques de Larosière**, chairman of the EU High-Level Group on Financial Supervision, whose report was published on 25 February, and subsequent statements by **Charlie McCreevy**, European Commissioner for Internal Market Services, at the EC Conference on Private Equity and Hedge Funds.

Detailed recommendations were then promulgated by the **International Organisation of Securities Commissions (IOSCO)** on 19 March in a consultation report on Hedge Funds Oversight. IOSCO's recommendations include: prime brokers and banks with exposure to hedge funds should provide information on their exposure to hedge fund counterparties and have risk management controls over such exposures; hedge fund managers should be registered and supply information to regulators including on investment strategies; and risk management mechanisms and capital requirements.

The regulation of capital pools was also on the **G20 Leaders'** agenda in the April summit. They agreed that hedge funds (or their managers) should be registered (subject to a minimum size), required to regularly disclose information to supervisors and have adequate risk management. Further, in line with the IOSCO recommendation, it was agreed that supervisors should require institutions which have hedge fund counterparties should have effective risk management mechanisms to monitor the funds' leverage and set limits for single counterparty exposures.

The common theme running between these recommendations is that transparency should be improved by imposing information requirements. This is a key feature of the European proposals.

The proposed Directive

Which AIFMs fall within the Directive?

The scope of the Directive extends to managers established in the EU, of all funds (wherever domiciled) that are not regulated under the UCITS Directive, and which have total AIF assets under management of more than €100 million, or €500 million where funds have no leverage and with no redemption rights exercisable during a period of five years following the date of constitution of each AIF. The Commission has estimated that the majority of fund managers will fall outside the scope of regulation, although some may question the accuracy of the statistics presented.

Whilst the primary target appears to be regulating hedge fund and private equity fund managers, the Commission has not restricted the Directive to these two categories: managers of other funds such as real estate, commodity, infrastructure and other institutional funds are also to be regulated. The Commission has adopted this approach on the basis that an arbitrary definition of hedge funds and private equity funds might not adequately capture all the relevant actors and could be easily circumvented, and because of the Commission's perception that many underlying risks are also present in other types of AIFM activity. However, the current draft appears to go far beyond even alternative funds and could include traditional long-only funds and listed funds.

Why regulate the AIF sector?

The decision to regulate the AIF sector may be a disproportionate response in circumstances where it is widely acknowledged that it did not play a major role in the emergence of the crisis. Mr McCreevy himself has stated that *"Hedge funds and private equity have become central in this debate. In political terms, this may be understandable ... Now as the financial system crumbles, they are easy scapegoats for more deep-rooted problems. Before we rush out to point the finger of blame we should not forget that hedge funds and private equity have not been central to the crisis, and it is not just me that says so"*. The de Larosière report did indeed not conclude that hedge funds caused or played a significant role in the crisis.

A sweeping approach

Private equity groups in particular have levied criticism against the proposals to regulate managers of the sector, and not to distinguish them from hedge funds. Indeed the Explanatory Memorandum of the Directive acknowledges that private equity funds did not contribute to an increase in macro-prudential risks. Further, the regulation of private equity fund managers (and indeed other alternative investment fund managers), does not sit squarely with the Commission's previous approach which focused on hedge funds: the Commission's consultation paper was framed entirely on hedge funds issues; de Larosière spoke of concerns and made recommendations associated with hedge funds; further, and perhaps most significantly, Mr McCreevy had stated that any regulatory action should distinguish between hedge funds, private equity and other forms of alternative investment, on the basis that the vehicles raise different issues which call for suitably differentiated responses. Nor does this approach sit squarely with what the IOSCO or the G20 Leaders had in mind insofar as those proposals had focussed on hedge funds. Whilst the Directive does allow for some differentiation between strategies, it is unclear whether this will go far enough.

Authorisation of AIFMs

The Directive proposes an authorisation and supervisory regime for all AIFMs established in the EU who manage one or more AIF wherever the AIF is domiciled. AIFMs established in the EU who do not provide management services to AIFs domiciled in the EU and who do not market AIFs in the EU are not covered by the Directive.

The Commission is seeking to regulate the conduct of managers, as opposed to the funds themselves, despite calls from certain opponents to the hedge fund and private equity industry.

Capital requirements

The proposed Directive stipulates that AIFMs must have an initial and ongoing capital of at least €125,000. Further, when the value of portfolios exceeds €250 million, AIFMs must provide an additional amount of their own funds equal to 0.02% of the amount by which the value of the portfolio exceeds €250 million. It is interesting to note that there are no capital or liquidity requirements for funds themselves.

Professional investors only

Authorisation as an AIFM will entitle the management, administration and marketing of the AIF to professional investors, as defined by MiFID (Annex II), in other Member States. The restriction to professional investors has been proposed on the basis that many AIFs entail a relatively high level of risk and/or have features which render them unsuitable for retail investors. Each Member State will remain free to determine whether funds managed by some or all AIFM can be distributed to retail investors in their Member State and to impose any additional requirements that they see fit.

Disclosure to regulators

In order for regulators to address the macro-prudential oversight of AIFM activities, AIFMs will be required to report to their home regulator on a regular basis. Matters to be regularly reported include:

- Principle markets and instruments in which the AIF trades.
- Aggregated information on the main instruments in which the AIF trades, markets of which it is a member or where it actively trades.
- Principal exposures and most important concentrations.

In addition, AIFMs will be obliged to "periodically" report:

- Percentage of AIF's assets which are subject to special arrangements arising from their illiquid nature.
- Any new arrangements for managing AIF liquidity.
- Actual risk profile of the AIF and risk management tools employed by the AIFM to manage these risks.
- Main categories of assets in which the AIF has invested.
- Use of short selling.

Disclosure to investors

So as to improve transparency, AIFMs will be obliged to supply investors with a variety of information prior to investment in the AIF, and subsequently on a regular basis including by way of an annual report. The annual report would also contain financial data and would be provided to the home regulator. Many of the additional disclosures reflect existing standards such as those of the Hedge Funds Standards Board. Information to be provided before investment includes:

- Description of investment strategies, assets which the AIF can invest, trading techniques and associated risks and restrictions to the use of leverage.
- Description of procedures by which the AIF may change its investment strategy and/or policy.
- Identity of the AIF's depositary, valuer (and valuation procedure) and auditor and description of the investors' rights should any failure arise.
- Description of the AIF's liquidity risk management, including the redemption rights both in normal and exceptional circumstances, existing redemption arrangements with investors, and how the AIFM ensures a fair treatment of investors.
- Details of any preferential treatment given to investors.
- Details of the legal regime applicable to the contractual arrangements.
- Details of fee arrangements.

Information to be provided periodically, subsequent to the investment includes:

- Percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature.
- Any new arrangements for managing the liquidity of the AIF.
- Current risk profile and management systems employed to manage these risks.

As with disclosures to regulators, it is not yet clear when the regular or periodical reporting obligations would be triggered, although the Directive provides that the Commission will subsequently adopt implementing measures specifying the frequency of disclosures.

Leveraged funds

Where an AIFM manages an AIF which employs "high levels" of leverage on a systematic basis, further reporting obligations to its local regulator and investors will apply. For these purposes "high levels" of leverage means a debt to equity ratio in excess of 1:1 in two out of the previous four quarters. Local regulators will also be given express powers to impose leverage limits in the event of potential systemic risks. In addition, the Commission will have powers to set limits to leverage, taking into account the particular strategy and sources of leverage for a relevant AIF.

Funds acquiring controlling interest in companies

AIFs, such as private equity funds, which acquire 30% or more of the voting rights of companies need to notify the company, other shareholders and employee representatives of the voting rights acquired. The notification will also need to address potential conflicts of interest, certain development plans and certain employment matters. The annual report for the AIF would also need to contain further details on the relevant investment including its operation and financial development and employee matters.

Critically, where following an acquisition of 30% of a company by an AIF, shares of that company are delisted from a regulated market, periodic and ongoing disclosure requirements under the Transparency Directive will continue to apply two years from delisting. The private equity industry has pointed out that such a requirement is not imposed on other private buyers.

This requirement will not apply where the company has fewer than 250 employees, an annual turnover not exceeding €50 million and/or an annual balance sheet total not exceeding €43 million. A number of commentators have suggested that this sets the bar for these reporting requirements far too low.

Independent valuation requirement

All assets of the AIF will need to be valued at least once a year and each time shares or units of the AIF are issued or redeemed. Valuations will need to be conducted by an independent valuer. The valuation rules to be applied are those of the country in which the AIF is domiciled, or in the AIF rules or instruments of incorporation. AIFMs must ensure that the valuer has appropriate and consistent procedures to value the assets in accordance with the applicable accounting standards and rules. This is likely to impose significant burdens on AIFMs and appears particularly inappropriate for closed-ended funds.

Separate depositary

AIFMs will need to arrange for a depositary for each AIF it manages, being an authorised credit institution with a registered office in the EU. The depositary will be responsible for maintaining segregated accounts and safekeeping financial and other assets (including unquoted assets). The depositary will also be liable to the AIFM and investors of the AIF for any losses suffered as a result of the depositary's failure to perform its obligations under the Directive.

New passporting rights to market funds in EU

AIFMs established in the EU will enjoy new passporting rights to market funds to professional investors in other EU Member States, on the basis of the authorisation obtained from their home regulator. Cross-border marketing would only be subject to a notification procedure under which relevant information is provided to the home regulator by the AIFM and transmitted to the other regulator in which the AIF is to be marketed.

AIFMs authorised in one Member State will also be entitled to manage AIFs in other Member States, either directly or through a branch.

Marketing of AIFs domiciled in third countries

The proposed Directive will provide rights for AIFMs to market non-EU funds in the EU in the following circumstances:

- The third country must have signed an agreement with the Member State for the exchange of tax matters and ensure effective exchange of such information.
- The valuer must fulfil the same requirements as those listed above (i.e. independence etc), and be subject to EU equivalent valuation standards.
- Safekeeping of assets by depositaries domiciled in a third country is only permitted for offshore AIFs, if the AIFM's home regulator is satisfied that the depositary is subject to prudential supervision and appropriate cooperation arrangements are in place with that depositary's regulator. The use of sub-depositaries is also permitted subject to further conditions.

The Commission considers that more time will be needed to do the necessary groundwork to make this a success. Therefore the rules allowing the marketing of third country funds will come into force three years after the Directive. In the meantime, third country funds will continue to be sold in those Member States which currently allow that.

Marketing of AIFs by non-EU AIFMs restricted

Generally, entities which are not properly authorised in an EU state will not be allowed to provide management services to AIFs or market units or shares in AIFs within the EU.

Non-EU AIFMs may market AIFs to professional investors in the EU where:

- The third country has appropriate levels of legislation regarding prudential regulation and ongoing supervision.
- The third country provides equivalent access to EU AIFMs.
- There is an appropriate cooperation agreement in place between the relevant EU state regulator and the regulator of the non-EU AIFM.
- Certain information is provided to the relevant EU regulator.

This is likely to raise significant issues for non-EU managers. As above, these rules would only come into force three years after the Directive. In the meantime arrangements will be governed by the local law of each EU state.

Other important requirements

- AIFMs must have documented and effective **internal procedures and controls** in order to mitigate and manage risks and prevent conflicts of interest.
- AIFMs must adopt **liquidity management** procedures and regularly conduct stress tests.
- Where an AIFM proposes to invest in securities or financial instruments issued after 1 January 2011 relating to **repackage loans** on behalf of an AIF, the Commission will set out new requirements governing such investments, including a requirement that the originator retains a net economic interest of at least 5%.
- AIFMs which intend to **delegate their functions** to third parties must obtain prior authorisation from their home regulator. Delegation to the extent that the AIFM can no longer be considered the manager of the AIF will not be permitted in relation to even non-EU assets.
- AIFMs must act in their conduct of business act in accordance with **general principles**, for example to act honestly, with due skill, care and diligence, in the best interests of the AIF and fairly.

Sanctions for failure to comply with rules

The Directive proposes that home regulators, may take the following measures against AIFMs in respect of breach of the rules:

- withdrawal of authorisation;
- imposition of a temporary prohibition of activity;
- adoption of appropriate measures to ensure that AIFMs continue to comply with legal requirements; and
- referral for criminal prosecution.

The Directive provides that home regulators may disclose to the public any measure or sanction imposed for infringement, unless such disclosure would seriously jeopardise the financial markets, be detrimental to the interests of investors or cause disproportionate damage to the parties involved.

Conclusion

The process of placing global financial markets on a more secure footing will also require action at international level – it is not yet clear how the Directive will fit in with the new international architecture established by the G20 and IOSCO.

It is also questionable how this regime will operate in relation to funds listed on an EU exchange and benefiting from passporting requirements under the Prospectus Directive.

Significantly, the Commission is seeking powers in the proposed Directive to issue further implementation detail covering many aspects of the Directive and thus effectively set detailed rules at an EU level for adoption by Member States. This clearly gives scope for further discussion and debate.

Given that the Directive is based on Article 47(2) of the EC Treaty it will be adopted under the co-decision process. This means that it will first be submitted to the European Parliament, which can propose amendments and ultimately reject the proposal. If approved, the Directive may then be adopted by the Council by a qualified majority.

The Commission has proposed that the Directive could come into force in 2011, if political approval is reached by the end of this year. Given the significant criticisms so far mounted internationally, this timetable may be optimistic.

Contacts

Herbert Smith

London

Nigel Farr

+44 20 7466 2360

Stibbe

Amsterdam

Michael Molenaars

+31 20 546 06 38

Paul Quist

+31 20 546 03 58

Rogier Raas

+31 20 546 05 90

Erna Moerdijk

+31 20 546 04 64

New York

Lennaert Posch

+1 212 972 40 00