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Proposal for a Directive on Alternative Investment Fund Managers

Background

The European Commission published its draft of the Directive on Alternative Investment Fund Managers (Draft Directive) on 29 April 2009. The Draft Directive provides a regulatory framework for managers of hedge funds, private equity firms (*as outlined in a recent Squire Sanders CEE Private Equity Alert*) and other alternative investment vehicles, but not for the funds themselves. The Draft Directive was published in response to the wide range of deficiencies exposed by the recent, and ongoing, financial crisis. The financial crisis has necessitated a comprehensive review of the European and national regulatory and supervisory frameworks for all significant players in EU financial markets.

The particular aim of the Draft Directive is to provide a common regulatory and supervisory framework with regard to alternative investment funds and, more specifically, hedge funds. This goal has also been addressed by the International Organization of Securities Commissions (IOSCO) task force and by the European Commission consultation paper on hedge funds dated 18 December 2008. To this end, the Commission launched a public consultation that posed several questions regarding systemic risks, market integrity, and efficiency, risk management and transparency of investors and investor protection. The responses to the consultation were intensively discussed at a conference in Brussels on 27 February 2009 and have been used both as input for the Draft Directive (with regard to a regulatory proposal for hedge funds) and as EU input for the G-20 measures.

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Overall, the Draft Directive can be regarded as a compromise between the regulation heavy position taken by France and Germany and the position of other EU Member States, such as the United Kingdom, which argue that stricter regulation might increase the Alternative Investment Fund's (AIF) operating costs, force the dissemination of proprietary information and ultimately drive financial firms and their investment managers out of Europe.

Following the outcome of, *inter alia,* the hedge fund consultation, the European Commission has selected and targeted measures regarding the activities of AIF managers, defined as all funds that are not harmonized under the Undertakings for Collective Investment in Transferable Securities Directive (UCITS Directive). Consequently, the Draft Directive covers not only hedge funds and private equity funds, but also all kinds of alternative investments, such as real estate funds (both closed- and open-ended) and all special funds for institutional investors. Furthermore, according to the understanding of the European Commission, since the AIF is basically a legal structure for the pooling of assets, the AIF managers are mainly responsible for all key decisions in relation to the management of the funds and therefore need to be regulated. Key decisions include those made on: (i) investment; (ii) the use of leverage; (iii) the governance structure and internal systems for risk management and the avoidance of conflicts of interest; (iv) the management of relationships with investors, counterparties and regulators (including the provision of information); (v) the organization of administrative functions (including valuation); and (vi) the safekeeping of assets and audits (even if these functions are delegated to third parties).

Actually, the regulatory environment for AIF managers is fragmented in Member States, but it has to be noted that many of the managers are already subject to regulation and supervision by their respective home Member States. However, the scope and content of national regulatory and supervisory regimes vary significantly, for example, with regard to requirements for registration and authorization, regulatory reporting and standards for investor disclosure and risk management. This regulatory fragmentation results in risks to counterparties and the overall financial system. Therefore, the following regulatory aims have been sought:

- To satisfy a common set of requirements for the fund managers and enhance transparency of the funds to supervisors, investors and other key participants;

- To require improved standards for internal organization, risk management (counterparty and operation) systems, liquidity and the management of conflicts of interest;

- To remove barriers so that a cross-border sale of AIFs within the European Union is permitted to professional investors; and

- To grant third country funds market access to the European Union only after a transitional period of three years.

Central Points of the Draft Directive

The central points of the Draft Directive include:

- **Coverage:** Managers of hedge funds and other funds such as real estate/infrastructure funds located in the European Union with portfolios exceeding €100 million, as well as private equity managers (or non leveraged AIFs without redemption rights within five years) of portfolios of more than €500 million.

- **Authorization:** Each manager will need to obtain authorization from the relevant financial regulator in the Member State in which he or she is located (e.g., SFA or BaFin). Managers must provide the regulator with comprehensive information concerning the suitability of their qualifications, planned activity, identity and characteristics of the funds (including the identities of fund members and the fund-related rules), governance mechanisms, arrangements for the valuation and safekeeping of assets, audit arrangements and regulatory reporting systems.

- **Marketing of funds:** Once authorized, managers may market their products to professional investors (in line with the Markets in Financial Instruments Directive (MiFID) definition) in all European Member States. However, cross-border marketing is subject to the filing of information with the host Member State authority. The Draft Directive proposes that AIFs domiciled in a "third country" may be marketed in the European Union only from 2014 onward (or three years after the Directive becomes law in Europe). Such third country funds are treated differently because the European Commission requires more time to check (i) whether the standard of regulatory frameworks and supervisory arrangements in those countries is equivalent to that required under the Directive; (ii) that the third country has entered into an agreement based on the

OECD Model Tax Convention (Art. 26); and (iii) that EU AIFs enjoy comparable access to that third country market. In the meantime, Member States may allow managers to market AIFs domiciled in third countries to professional investors on their territory subject to national law.

- **Operating conditions:** In order to become and continue to be authorized, managers must demonstrate that they are suitably qualified and satisfy the relevant regulator as to the risk management arrangements in place in respect of liquidity, operational and counterparty risk, the management and disclosure of conflicts of interest, the fair valuation of assets, and the security of depository and custodial arrangements.

- **Continuous reporting obligations to relevant regulators:** Managers must regularly report on the principal trading markets and supply aggregated information on the main trading instruments and principal exposures (on a quarterly and yearly basis). Furthermore, they must report on the percentage of assets subject to special arrangements arising from their illiquid nature, the actual risk profile of the fund, its risk management tools and any use of short selling. Further, the assets of the funds have to be valued by an independent party on a yearly basis.

- **Additional disclosure obligations for high leverage levels:** Managers must disclose to regulators and investors the maximum level of leverage that will usually be used (i.e. cash, securities or derivatives), the main sources (prime brokers, banks, etc.), the total amount of leverage actually used and the names of the five lenders with the highest lending volume. Furthermore, rules will be introduced to limit leverage depending on the nature of the underlying fund. In this regard, a high level of leverage is defined as cases in which the amount of leverage employed exceeds the value of the fund's equity capital.

- **Identification of conflicts of interest:** Managers will need to take all reasonable steps to identify conflicts of interest between their fund managers, employees or persons otherwise linked to the fund and their investors. They must also take the same steps to identify such conflicts between their investors.

- **Risk management setup:** Managers must

separate the functions of risk management and portfolio management, and implement systems to measure and monitor all specific risks associated with each fund and its investment strategy. In particular, managers must observe the liquidity profile and conduct regular stress tests.

- **Short selling management:** There are currently no restrictions on short selling, but managers must also adequately manage the risks associated with the delivery of short-sold securities and instruments.

- **Minimum capital requirements:** Managers are required to hold and retain a minimum level of capital of at least €125,000, plus 0.02 percent of the amount by which the value of the portfolios exceeds €250 million.

- **Disclosure to investors:** Investors must be provided with a description of the fund's objectives and investment strategy. This must include a description of the assets in which the AIF may invest, the investment techniques that may be used, details of the circumstances in which leverage may be used, the types of sources of leverage permitted and any associated risks. Managers must also provide an annual report to investors and relevant regulators. The report must contain statements in respect of assets and liabilities, income and expenditure, and activities for the financial year.

Next Steps

Ultimately, the Draft Directive needs to be approved by the European Parliament and the European Council, pursuant to the EU Co-Decision Procedure, which could happen this year, with entry into force in 2011. However, due to the European elections in early June, the performance of the Lamfalussy process and the widespread controversy regarding the regulatory and supervisory goals of the Draft Directive, adoption may not occur until 2010, meaning an entry into force in 2012. It must be emphasized that the requirements outlined in the Draft Directive are the minimum standards that Member States must implement, and it can be expected that France and Germany, for example, will pass even stricter requirements in 2011 or 2012.

For more information on the Draft Directive, please contact Squire Sanders European partner Dr. Andreas Fillmann or your principal Squire Sanders lawyer.

to individual situations or as legal opinions concerning such situations. Counsel should be consulted for legal planning and advice.