

European Commission Announces Draft Directive on Alternative Investment Fund Managers

On 29 April 2009, the European Commission announced that it was proposing a draft Directive on alternative investment fund managers, following a consultation paper on hedge funds issued in December 2008. The contents of the draft Directive had been widely leaked beforehand, and attracted widespread criticism. The draft Directive now goes to the European Parliament and the Council for further consideration.

At the time of writing, the Commission had not yet published the text of the draft Directive. The following is based on the Commission's press release and its list of frequently-asked questions ("FAQs").

Though the consultation paper was confined to hedge funds (and Charlie McCreevy, the Commissioner for the Internal Market and Services, had stated, when announcing the consultation in a speech to the Economic and Monetary Affairs Committee of the European Parliament on 1 December 2008, that private equity 'does not pose any significant threat to financial stability'), the draft Directive applies to both hedge funds and private equity funds. The British Private Equity and Venture Capital Association ("BVCA") has stated that consultation with the private equity industry 'has been non-existent'. This would have been understandable, had the proposed Directive arising out of the consultation been limited to hedge funds. However, as the scope of the proposals has been extended to cover private equity, the BVCA ought to have been consulted, given that the UK is home to more than half of the European private equity industry. Furthermore, the draft Directive renders all the responses to the consultation partial at best: respondents may well have had views on the position of private equity funds, but understandably chose to suppress them when responding to a consultation paper on hedge funds. The consultation process therefore seems flawed, and it is no surprise that in objecting to the Commission's proposals, both the BVCA and the Alternative Investment Management Association ("AIMA") saw political considerations rather than economic ones behind the proposals. European elections occur in June, and hedge fund managers and private equity groups have long been certain politicians' favourite financial *bêtes noires*, even if it is generally agreed (for instance, in the analysis contained in *The Turner Review* published in March 2009) that they played only a peripheral role in the current financial crisis.

The main provisions of the draft Directive are as follows:

Application

Managers of alternative investment funds ("AIFs") (defined as any funds that are not regulated under the UCITS Directive) who have assets under management of more than €100 million will need to be authorised by their home state, and subject to ongoing requirements. However, if the AIF has no leverage, and a lock-in period of five years or more, the threshold is raised to €500 million.

The leaked draft of the Directive had a single threshold of €250 million; the last-minute change appears to have been designed to address political criticism (in particular from Poul Nyrup Rasmussen, President of the Party of European Socialists) that the threshold was too high, and criticism from the private equity industry that the threshold was too low. Consequently, start-ups and venture capital funds are likely to be able to take advantage of the €500 million threshold. Other funds, however, will not. The Commission estimates that roughly 30% of hedge fund managers (managing almost 90% of assets of EU-domiciled hedge funds) would be covered by the Directive.

The wide definition of AIFs means that not only hedge funds and private equity funds are covered; the term also includes real estate funds, commodity funds and infrastructure funds.

Managers of AIFs that are below the €100 million or €500 million threshold will remain subject to their home state regulation and supervision. The Commission's FAQs indicate that there will be a mechanism for such managers to 'opt in' to regulation under the terms of the draft Directive, and that there might be a strong incentive to do so if the managers are interested in cross-border business. The implication of this is that managers of AIFs that do not fall within the scope of the draft Directive will not be able to market such funds cross-border, even if they can currently do so, which would be a major and unwelcome change.

It is not clear from the statements of the Commission what would happen to a manager of an AIF that, in the course of the year, increased (or decreased) in value such that it crossed the threshold. The Commission has indicated that it sees the "Lamfalussy Process" applying to the draft Directive, as it did to the Markets in Financial Instruments Directive ("MiFID"). This means that the draft Directive will set out only the broad regulatory framework at "Level 1", leaving the more detailed requirements to appear in a further Directive at "Level 2", made by the Commission only, on advice from the Commission of European Securities Regulators ("CESR"). Issues of this nature are thus likely to be covered in the "Level 2" Directive.

Reporting requirements

The ongoing requirements to which the manager of an AIF will be subject will include reporting to its regulator on a regular basis the principal markets and instruments in which it trades, its main exposures, performance data and concentrations of risk. Managers of AIFs will also be required to report to the regulator the identity of the AIF, the markets and assets in which the AIF will invest, and the organisational and risk management arrangements established in relation to the AIF (assuming that the last point is fully covered, this could presumably be done by providing a copy of the offering memorandum). Managers who manage leveraged AIFs or who control stakes in companies would be subject to additional disclosure obligations.

Capital requirements

Managers of AIFs will be required to hold a minimum amount of capital, of €125,000. However, if the assets under management exceed €250 million, the manager will be subject to an additional capital requirement. For those smaller fund managers in the UK who are currently required to hold regulatory capital of only £5,000, this will mean a significant increase.

Marketing

Managers of AIFs may market AIFs across the European Union to professional investors (as defined in MiFID). They may also market AIFs to retail investors, if the Member State of the retail investor allows it. As the industry has long argued for a private placement regime covering the whole of the EU, this part of the draft Directive is likely to be welcomed, as it should make it much simpler to market AIFs cross-border.

Disclosure

Managers of AIFs are required to make various disclosures to investors, both pre-investment and on an ongoing basis, including disclosures relating to the risk, return and liquidity characteristics of the AIF, the identity of the service providers to the AIF and the manager's risk-management systems. They must also disclose the percentage of the assets of the fund that are subject to special arrangements because of their illiquidity (for example, held in side pockets).

Scope

The draft Directive applies only to AIFs domiciled in the European Union. Assuming that the Directive is in force by 2011 (as the Commission hopes), AIFs domiciled outside the European Union (such as hedge funds domiciled in the Cayman Islands) may continue to be marketed to those Member States currently allowing this until 2014. After that date, non-EU AIFs will be capable of being marketed in the EU only if they ‘comply with stringent requirements on regulation, supervision and co-operation, including on tax matters’.

The Commission provides no details on what these requirements might be, other than that they will be ‘stringent’. It further observes that more time is needed for preparation, and that this approach is consistent with the objectives of the G20 to enhance the transparency and the quality of regulation in offshore financial centres. But at the very least, the proposal for such requirements calls into doubt whether most, if not all, hedge funds currently domiciled overseas could continue to be offered within the EU after 2014, if their state of domicile has not introduced a more intrusive regulatory regime. One of the purposes of the draft Directive would therefore appear to be to regulate offshore AIFs indirectly: that is, by making it impossible for them to be marketed in Europe after 2014 unless they satisfy certain regulatory and transparency standards.

The consequences of this appear to be as follows:

- In the short term, the proposed Directive will have no effect on managers of AIFs if the manager and the AIF are located outside the EU (including in the US). They will be able to market the AIF to investors in the EU on the same basis as currently. In 2014, however, that position will change dramatically. Both the AIF (and, it would seem, the manager) will need to comply with new and presumably detailed requirements before the AIF can be marketed in the EU, although if those requirements are met it would appear that the AIF will be able to be marketed anywhere in the EU to professional clients. It will be interesting to see whether, as a result, certain managers of AIFs will have a marketing strategy that excludes the EU.
- For managers of AIFs who are established within the EU, but where the AIF is outside the EU, it would appear that the manager would be subject to the provisions of the draft Directive, but would remain subject to the same requirements as currently apply when marketing the AIF within the EU. From 2014, the position will change, as outlined in the previous paragraph.
- If the AIF is established within the EU, and the manager is outside the EU, the position is unclear. It would seem that the manager would not be caught by the Directive and, since the Directive is aimed at fund managers, not funds themselves, there would be no impact on the fund either. The Commission’s FAQs are not particularly helpful on this point; it is to be hoped that the text of the draft Directive will clarify the position.
- The draft Directive is also unclear on the extent to which distributor firms will be affected. For instance, if the manager can market AIFs to professional investors throughout the EU, can a distributor of those funds who is not the manager do so? Logic suggests that this should be the case, but that level of detail may have to await the “Level 2” Directive (for which see under “Application” above).

Initial reaction to the draft Directive from both the BVCA and AIMA has been wholly negative, with the former describing the proposed Directive as ‘irrational’ and the latter as containing ‘many ill-considered provisions which are impractical and may prove unworkable’. If the draft Directive comes into force, for all that some of the proposals will have no or a very limited effect on UK alternative fund managers (who are required to be authorised under present arrangements and to make regular reports to the FSA), the alternative funds world in the UK will look very

different. Two obvious casualties would be the Hedge Fund Standards Board and the Guidelines Monitoring Group, as there would no longer be a place for self-regulation in the industry. Given the strength of the opposition to the proposals, it will be interesting to see whether the industry view will be able to modify the draft produced by the Commission.

Chicago Office
+1 312.583.2300

Frankfurt Office
+49.69.25494.0

London Office
+44.20.7105.0500

Los Angeles Office
+1 310.788.1000

New York Office
+1 212.836.8000

Shanghai Office
+86.21.2208.3600

Washington, DC Office
+1 202.682.3500

West Palm Beach Office
+1 561.802.3230

Copyright ©2009 by Kaye Scholer LLP. All Rights Reserved. This publication is intended as a general guide only. It does not contain a general legal analysis or constitute an opinion of Kaye Scholer LLP or any member of the firm on the legal issues described. It is recommended that readers not rely on this general guide but that professional advice be sought in connection with individual matters. References herein to "Kaye Scholer LLP & Affiliates," "Kaye Scholer," "Kaye Scholer LLP," "the firm" and terms of similar import refer to Kaye Scholer LLP and its affiliates operating in various jurisdictions.