European Commission Proposes New Regulatory System for Hedge Funds and Private Equity Funds

On April 30, 2009, the European Commission (the "Commission") published a proposal for a Directive on Alternative Investment Fund Managers (the "AIFM Directive"). The AIFM Directive will regulate managers ("AIFMs") of so-called "Alternative Investment Funds" ("AIFs"), in particular hedge funds and private equity funds. The European Union (the "EU") legislative process is long and complex, and the AIFM Directive will be reviewed and revised by numerous bodies. The earliest that the AIFM Directive could plausibly be adopted is late 2010, but the legislative process could easily drag into 2011 or even 2012.

The AIFM Directive covers AIFMs established in an EU Member State that manage or market AIFs in the EU. AIFMs will be subject to extensive ongoing regulatory requirements, including reporting and disclosure requirements. Certain provisions of the AIFM Directive overlap with other EU directives, in particular the EU Markets in Financial Instruments Directive ("MiFID"), but other requirements are novel, including requirements governing short selling, a requirement for a liquidity management system, the separation of risk and portfolio management, and disclosure of preferential treatment of certain investors.

This Memorandum summarizes the key provisions of the AIFM Directive and considers its potential impact upon the European AIF industry.

I. BACKGROUND

The AIFM Directive represents the culmination of years of political pressure from certain Member States, political groups in the European Parliament (the "Parliament") and various interest groups who have harbored suspicions relating to the activities of hedge and private equity funds, often with no clear understanding of the differences between them.

The pressure to regulate hedge funds and private equity funds has increased as a result of the economic crisis. In September 2008, the European Parliament adopted two reports calling for greater regulation, one focusing on hedge funds and private equity funds presented by Poul Nyrup Rasmussen, the Leader of the Party of European Socialists, and the other on the transparency of institutional investors, presented by

Klaus-Heine Lehne, of the European Peoples' Party. In February 2009, the European Commissioner for the Internal Market and Services, Charlie McCreevy, who had long opposed regulation of the type proposed by Rasmussen and Lehne, announced a proposal for the regulation of hedge funds. In a speech at the EC Conference on Private Equity & Hedge Funds, McCreevy set out six principles that should guide any future legislation, including the need to distinguish between hedge funds, private equity funds, and other alternative investment vehicles, each of which he said presents different challenges and requires a different regulatory approach. Also in February 2009, the de Larosière report on the future of European supervision and regulation, commissioned by the President of the Commission, José Manuel Durão Barroso, concluded that hedge funds "did not play a major role in the emergence of the crisis," but nevertheless advised that hedge funds' role in increasing leverage in the financial system gave rise to a need for greater regulatory transparency.

Accordingly, in March 2009 the Commission published a communication laying out a broad program for greater regulation of the financial industry, including a higher level of harmonization and regulation at the European level. Among these proposals, which were endorsed by the European Council in advance of the April G20 meeting in London, was a directive establishing regulatory and supervisory standards for hedge funds and private equity funds – the AIFM Directive.

As described in the Commission's "Explanatory Memorandum," the AIFM Directive is intended to deal with perceived risks in a wide range of areas. These include "macro-prudential risks" (bank exposure to the sector and the pro-cyclical impact of "herding" and risk concentrations), "micro-prudential risks" (weaknesses in internal management systems), investor protection, market efficiency and integrity, the market for corporate control and the impact on companies controlled by AIFMs. The Commission recognizes that private equity funds do not raise "macro-prudential" concerns, but it wants to address perceived issues raised by private equity funds' governance of portfolio companies, as well as "micro-prudential" and investor protection issues common to all types of AIFMs.

The proposed AIFM Directive has received a mixed reception. Many commentators in the United Kingdom, which has a strong AIF industry, oppose the AIFM Directive. By contrast, the French finance minister, Christine Lagarde, and Mr. Rasmussen, have expressed the view that the proposed AIFM Directive is too weak and will not effectively regulate the AIF sector.

II. LEGISLATIVE PROCEDURE

The AIFM Directive will now progress through the EU's so-called "co-decision procedure," a complex legislative process in which a draft law proposed by the Commission is reviewed by a number of EU bodies and requires approval by the

Parliament and the Council of the EU (the "Council"), which consists of a government minister from each Member State and meets in different compositions depending on the policy area being addressed. In the case of the AIFM Directive, the Council will be composed of Member States' economics and finance ministers.[1]

The next procedural step after a measure is proposed by the Commission is the Parliament's "first reading," which involves the adoption of a report, in this case by the Parliament's Economic and Monetary Affairs Committee (known as ECON), under the leadership of a "rapporteur" acting in close cooperation with the Parliament's advisory Legal Affairs Committee (known as JURI).

In parallel with the Parliament's first reading, the draft will be reviewed by two standing committees of the EU, the Committee of the Regions and the Economic and Social Committee. The Council Presidency, a rotating position currently held by the Czech Republic (until July 1, 2009, to be followed by Sweden), will also form a working party to study the draft before the Parliament votes on proposed amendments.

The co-decision procedure is long-drawn-out in the best of circumstances, but in the present case the timing is complicated by the election of a new Parliament in June 2009 and the appointment of a new Commission, which will likely be inaugurated in late 2009. As a result, the earliest that the AIFM Directive would be likely to be adopted is late 2010, and adoption could easily slip until 2012.

After adoption, many general provisions in the AIFM Directive will need to be fleshed out through technical implementing regulations under the so-called "Lamfalussy procedure." The Commission will be assisted by technical experts from Member States' supervisory and regulatory bodies and is permitted to adopt an implementing regulation only in cooperation with one or more of certain specialist "Level 2" committees composed of high-level representatives of Member States' finance ministries, acting by qualified majority vote. It will therefore be some time before the full impact of the AIFM Directive will become clear.

III. AIFMS AND AIFS

The AIFM Directive applies to AIFMs established in the EU that provide "management services" or "market" interests in AIFs to investors in the EU. It will catch the operations of AIFMs, irrespective of the domicile of the AIF, whether the services are provided directly or by delegation, or the type or legal structure of the AIF. AIFs are defined as collective investment undertakings "whose object is the collective investment in assets."

[1] The Council of Economics and Finance Ministers of the European Union ("Ecofin").

The AIFM Directive contains a number of exemptions, including for any AIFM established in the EU that neither provides management services to an AIF domiciled within the EU nor markets AIFs within the EU. A separate exclusion exempts AIFMs whose assets under management do not exceed a threshold of EUR 100 million, or EUR 500 million when the AIFM's portfolio consists of AIF that are not leveraged and with no redemption rights exercisable during a period of five years following the date of constitution of the AIF. Also outside the scope of the AIFM Directive are "UCITS," retail funds which are subject to a separate regulatory regime, pension funds, endowments, sovereign wealth funds, portfolios traded for their own account by banks and insurance companies, and actively managed investments in the form of securities.

IV. AUTHORIZATION REQUIREMENT

An AIFM may only provide "management services" within the Community to any AIF or "market" shares or units thereof to EU investors if it is established in an EU Member State and authorized by the competent authorities of that State. "Management services" are defined as "the activities of managing and administering one or more AIF on behalf of one or more investors," but the terms "managing" and "administering" are not further defined.

An AIFM applying for authorization is required to provide the following:

- Information on the identities of the AIFM's shareholders or members and the nature / amount of their holdings in the AIFM (whether direct or indirect);
- Information on how the AIFM will comply with its obligations under the AIFM Directive; and
- "Detailed" information about the characteristics of the AIFs it intends to manage (including their fund rules and instruments of incorporation).

The competent authorities will be required to decide on applications for authorization within two months after submission of a complete application. An authorization may impose restrictions, in particular regarding the type of AIFs an AIFM can manage and its delegation arrangements.

V. MARKETING

An authorized AIFM is entitled to market shares or units of AIFs it manages to professional investors in all EU Member States. Before doing so, however, it must notify the competent authorities, which may impose restrictions or conditions, regarding the AIFs whose shares or units it intends to market. Marketing is defined as "any general offering or placement of units or shares in an AIF to or with investors domiciled in the Community, regardless of at whose initiative the offer or placement takes place." The term "general offering" is not defined, although it is likely intended to include typical private placements. Note that an offer or placement may be caught even if the initial contact comes from the investor.

Professional investors are defined by reference to the term "professional client" in Annex II of MiFID, which catches institutional and large corporate investors, plus certain other persons, including individuals, who may request to be treated as professional clients if they meet certain tests. Member State authorities may also allow marketing of AIFs to retail investors, but such authorization will be limited to their territories.

AIFs domiciled outside the EU (for example, funds managed by a U.S. fund manager but marketed by a placement agent which is an authorized AIFM), may continue be marketed for a period of three years after the AIFM Directive is required to be implemented, subject to the existing requirements of the laws of the Member State in which they are to be sold. After the three-year period has expired, the AIFM Directive will allow the marketing of a non-EU AIF only if its home state has signed an agreement with the investor's Member State complying with Article 26 of the OECD Model Tax Convention and ensuring an effective exchange of information on tax matters. In addition, the home Member State must "have particular regard" to conditions relating to the delegation of depositary functions performed by a non-EU depositary.

VI. OPERATING CONDITIONS

The AIFM Directive will impose a variety of conditions on the manner in which authorized AIFMs are organized and operate, including conditions relating to their conduct of business, capital requirements, appointment of a valuator and a depositary, and delegation of functions.

A. CONDUCT OF BUSINESS

The AIFM Directive sets out a series of general conduct-of-business requirements, including the following:

- No investor may obtain preferential treatment unless disclosed in the AIF rules or instruments of incorporation;
- Organizational and administrative arrangements must be in place to identify, prevent and disclose conflicts of interest;
- Risk management and portfolio management must be separated and subject to separate review;

- AIFMs will have to employ an appropriate liquidity management system, conduct stress tests and provide for appropriate redemption policies for each AIF they manage; and

- When engaging in short selling, an AIFM must implement procedures to ensure access to the financial instruments on the date when the AIFM committed to deliver them.

A number of these requirements appear to have been drafted with hedge funds in mind, since it is not clear how or why they would apply to private equity funds.

B. CAPITAL REQUIREMENTS

An AIFM must have own funds of at least EUR 125,000, plus 0.02% of the amount by which the value of the portfolio of the AIFM exceeds EUR 250 million. The proposal that regulatory capital relate, in part, to the value of the portfolio managed will prove controversial, as the risks to which an AIFM is exposed are not obviously directly related to the size of the portfolio that it manages.

C. VALUATION

An AIFM must appoint an independent valuator to establish the value of assets acquired by each AIF it manages and the value of the shares and units of these AIFs. The valuation must occur once a year and each time shares or units of an AIF are issued or redeemed if this takes place more frequently. The relation between the valuator's task and that of the independent auditor that will audit AIFs' accounts (see below) is unclear.

D. DEPOSITARY

For each AIF it manages, an AIFM must appoint a credit institution to act as an independent depositary. The depositary will:

- Receive all payments made by investors when subscribing for units or shares of an AIF managed by the AIFM and book them on behalf of the AIFM in a segregated account;

- Safe-keep any financial instruments which belong to the AIF; and

- Verify whether the AIF or the AIFM on behalf of the AIF has obtained the ownership of all other assets the AIF invests in.

The depositary must act independently and solely in the interest of AIF investors. Again, the requirement for a depositary seems targeted primarily at hedge funds, since private equity funds typically do not hold and trade significant amounts of liquid assets.

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E. Delegation

An AIFM must request prior authorization from its home-state regulator for the delegation of one or more of its functions to a third-party, which must itself meet certain requirements. Sub-delegation would be prohibited. The meaning of "delegation" and the scope of those functions which require authorization will require further clarification.

VII. TRANSPARENCY REQUIREMENTS

AIFMs must disclose information to potential investors before they invest and continue to provide information on an ongoing basis. AIFMs' disclosure requirements will cover matters including investment strategy, valuation procedure, liquidity risk management and arrangements regarding any investors who are entitled to receive preferential treatment. They must also "make available" an annual report with audited accounts for each AIF they manage. It is not clear whether these annual reports would need to be made available to the public, or only to investors in the relevant AIFs.

A separate set of obligations requires AIFMs to make reports to their regulators. AIFMs must regularly report to the competent authorities regarding the principal markets and instruments in which they trade and, for each AIF, its AIFM must periodically submit information relating to the AIFs it manages, and their liquidity, risk profile, categories of asset investments and investment strategy.

VIII. SPECIFIC OBLIGATIONS

A. Disclosure of High Levels of Leverage

Additional disclosure obligations apply to AIFMs managing AIFs employing high levels of leverage on a systemic basis (*i.e.*, where the combined leverage from all sources exceeds the value of the equity capital of the AIF on two out of the past four quarters). Leverage is defined as "any method by which the AIFM increases the exposure of an AIF it manages to a particular investment whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means." It is not clear whether this definition encompasses debt incurred by a portfolio company or special purpose vehicle (as in a private equity fund structure) rather than by the fund itself (as is more typical of a hedge fund structure).

B. Disclosure of Controlling Influence

AIFMs that acquire 30% or more of the voting rights of either an issuer or a non-listed company must notify the issuer or non-listed company, other shareholders and employees of certain information. The nature of the information that must be disclosed depends upon whether the company is listed. In the case of a public company that is delisted after being acquired by an AIF, the reporting obligations continue for two years from the date of delisting. Unlike many of the other provisions of the AIFM Directive, these provisions appear to be targeted specifically at private equity funds rather than at hedge funds.

IX. MUTUAL RECOGNITION

The AIFM Directive would permit Member States to authorize a non-EU-based AIFM to market AIF interests to investors in the EU (but not to provide "management services" in the EU). This possibility would be available only where the Commission has determined that the legislation of the relevant country regarding prudential regulation and on-going supervision is equivalent to the provisions of the AIFM Directive; it grants reciprocal market access to EU AIFMs wishing to market AIF interests in that country; and a cooperation agreement has been entered into between the non-EU regulator and the AIFM's home-state regulator providing for the exchange of information. The AIFM Directive provides that Member States will have three years from the date on which other provisions of the AIFM Directive must be implemented to apply the mutual recognition procedure. Since the mutual recognition procedure is voluntary, however, it is unclear whether Member States could apply the procedure sooner.

X. COMMENTARY

The AIFM Directive is poorly drafted and could impose duplicative and inconsistent obligations on hedge funds and private equity funds. Some of the most significant issues raised by the AIFM Directive are discussed below.

A. DUPLICATIVE REGULATION

The AIFM Directive overlaps with existing and proposed regulation both within and outside the EU. Within the EU, certain areas covered by the AIFM Directive area already addressed by MiFID and Directive 2006/49/EC, the Capital Requirements Directive, which implements Basel II. According to Recital 5 of the AIFM Directive, investment firms authorized under MiFID should not be required to obtain an authorization under the AIFM Directive to provide investment services in respect of AIFs, but it is unclear how the other requirements of the AIFM Directive would apply to AIFMs authorized under MiFID.

Outside the EU, U.S. hedge fund and private equity managers may be registered as "investment advisers" under the Investment Advisers Act of 1940 and broker-dealers under the Securities Exchange Act of 1934. As in the EU, U.S. regulators are considering further regulation in this area, potentially resulting in even more overlapping and inconsistent regulation. For example, two bills currently before the U.S. legislature that seek to regulate hedge funds and private equity funds would be likely to overlap, at least in part, with the AIFM Directive.

B. "One Size Fits All"

Although the Commission's Explanatory Memorandum recognizes that hedge funds and private equity funds raise different concerns and states that the requirements to which AIFMs are subject should be "tailored to the particular investment strategy employed," the AIFM Directive does not distinguish between requirements applicable to hedge funds and those applicable to private equity funds. Certain provisions in the AIFM Directive have clearly been designed with either hedge funds or private equity funds in mind. For example, the requirement of a depositary to hold fund money, "financial instruments" and "other assets" appears designed to prevent the recurrence of a Madoff-style fraud. On its face, however, the AIFM Directive treats all AIFs alike and does not exempt any category of funds from requirements that would be inappropriate for them.

C. Unclear Terms

Key terms in the AIFM Directive are not clearly defined, resulting in uncertainty as to exactly which entities and activities are covered. The application of the AIFM Directive to entities and activities outside the EU is particularly unclear, as is the application of the AIFM Directive to the structure of U.S.-based funds. Many such funds are advised by EU entities, but these entities typically have no authority to take decisions on behalf of AIFs, and therefore would not conventionally be regarded as "managing" them. Indeed, the Commission's "Frequently Asked Questions" about the AIFM Directive published on April 29, 2009 indicate that the Commission considers an AIFM to be the body within a fund structure that is "responsible for all key decisions in relation to the management of the fund," a description that would appear to exclude advisory bodies. Moreover, many of the AIFM Directive's provisions, such as capital, depositary, and liquidity management requirements, make little sense if applied to a purely advisory body.

Accordingly, there may well be pressure to amend or interpret the AIFM Directive so that it catches all private equity funds that invest in EU issuers and/or market shares or units to EU investors, regardless of where the ultimate parent or decision-making entity in the fund structure is based. It remains to be seen if, and how, the Commission solves this conundrum. For example, a prohibition on funds investing in EU companies, except through an authorized EU-based AIFM, would discriminate against U.S.-based funds and could be inconsistent with the EC Treaty guarantee of the free movement of capital.

D. Transitional Provisions

The AIFM Directive contains no provisions that would "grandfather" pre-AIFM Directive arrangements into compliance. AIFMs operating in the Community before the deadline for implementation will have one year to adopt all necessary measures to comply with the directive. Accordingly, certain existing fund structures may need to be recast and renegotiated if the AIFM Directive is implemented as proposed. For example, it will not be possible for an EU-authorized AIFM to delegate portfolio management to a manager which is not also so authorized, or for a non-authorized AIFM to manage AIFs domiciled in the EU. Moreover, the AIFM Directive applies to all AIFMs "established in the Community," indicating that authorization will not be open to non-EU managers except pursuant to the mutual recognition procedure, which will only become available under limited conditions three years after implementation.

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