

Draft European Directive on Alternative Investment Fund Managers: What it means for PE and Property Funds



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What is the Directive for?

Published on April 30 this year, the proposed Directive on Alternative Investment Fund Managers (AIFMs) is one of a range of steps the European Commission has recently taken in order to tighten financial market regulation and oversight in the wake of the global financial crisis.

The Directive has two stated goals:

First, to "establish a secure and harmonised EU framework for monitoring and supervising the risks that AIFMs pose to their investors, counterparties, other financial market participants and to financial stability."

Second, to "permit, subject to compliance with strict requirements, AIFMs to provide services and market their funds across the internal market."

If the draft Directive is ratified in its current form, Managers and Administrators of all non-UCITs funds would be obliged to comply with it – with two exceptions:

- Managers of AIFs with total assets of less than €100m.
- Managers of AIFs that have no leverage; that do not grant investors redemption rights for a period of five years following the constitution of the fund; and that have total assets of less than €500m.

The Directive is explicitly focused on regulating Managers and Administrators of AIFs, rather than the funds themselves. Why? Because the European Commission argues, "financial stability and investor risks stem primarily from the conduct and organisation of the Manager and the providers of key services, notably the depository and valuation agents."

The terms of the Directive cover Managers of all AIFs in the European Union – regardless of the legal domicile of the fund being managed.

When will the Directive come into force?

The European Commission has said that it hopes to reach a political agreement on the final terms of the Directive by the end of 2009. If this proves to be the case, the Directive could be implemented by EU member states by 2011. Managers of EU domiciled funds would then be given one year to comply with the new rules. Managers of funds domiciled outside the EU would be given three years to comply.

However, many observers believe that intense fund industry lobbying and political debate over the terms of the proposed Directive will mean that the legislation is unlikely to be finalised until 2010, with implementation by EU member states taking place in 2012.

How will the Directive affect Managers of PE and property funds?

All Private Equity and Property Fund Managers operating funds within the EU (excluding those meeting the exception criteria described above) will need to obtain authorisation from the regulator in their own member state in order to operate. An AIF Manager with authorisation in one EU member state will have the right to market its funds to professional investors in any other member state. However, permission to market funds to retail investors will remain at the discretion of each member state.

The terms of the draft Directive state that specific criteria for authorisation by the regulator will vary according to the investment strategy used by the fund in question (in other words, the Commission has not worked these criteria out yet). However, all Managers of AIFs will be required to:

- Hold and retain a minimum level of Capital.
- Provide "detailed information" on planned fund activity; the identity and characteristics

of the fund managed; governance; arrangements for the valuation and safekeeping of assets; and reporting systems.

- Satisfy the regulator that risks are being managed on an ongoing basis. Specific attention will be paid to risks relating to liquidity; short selling; fair valuation of assets; conflicts of interests; and security of custodial/depository arrangements.
- Provide investors with a "clear description" of investment policy, including details of asset types; use of leverage; redemption policy; valuation, custody, administration and risk management procedures; and fees, charges and expenses associated with the investment.
- Provide the regulator with regular reports on the principal markets and instruments in which they trade and their fund's principal exposures, performance data and risk concentrations.
- Seek permission from the regulator in their home member state before delegating any function to a third party (see section below titled "The question of outsourcing" for further details).

The proposed Directive also empowers the European Commission to set leverage limits and gives regulators in EU member states the authority to restrict the leverage used by specific Managers and funds in "exceptional circumstances".

In addition, the Directive requires AIFMs who acquire controlling stakes in companies to disclose information to other shareholders in the company, and to employee representatives. This information is likely to include reports on portfolio company performance, and the investment strategy and objectives of the fund as a whole.



Industry reaction to the Directive

Leading members of the AIF community have expressed deep concern over aspects of the draft Directive. For example, in a Common Position Paper published on June 26th this year, the European Venture Capital Association (EVCA) argued that the legislative proposals within the Directive do not take into account the differences between various types of funds, and the risks associated with them. In short, argues the EVCA, proposals designed primarily for regulating hedge funds would be foisted upon Managers of all forms of AIF. This would result in "inappropriate, irrelevant or disproportionate" regulation of the AIF industry, the association says.

Against the backdrop of these concerns, the EVCA has called for a series of amendments to the draft Directive. These include:

- The exemption from the Directive of AIFMs managing less than €1bn of assets.
- More accommodation of the differences between various types of AIF, especially with regard to capital requirements, independent valuations and depository/custody functions.
- Changes to the fund disclosure requirements as they stand in the existing draft. "Any provision which requires prior approval of marketing material, and subsequent changes to marketing provisions, will severely curtail the collaboration between Manager and professional fund investors in structuring and negotiating fund terms to meet the requirements of those investors," argues the EVCA.
- Changes to portfolio company disclosure requirements. "Disclosure requirements at the company level should be addressed in corporate laws governing companies and their shareholders rather than in a regime for Fund Managers alone," the EVCA says.
- Review "third country requirements" in order to prevent them from hampering Managers' ability to operate funds internationally.
- Introduce grandfathering clauses for requirements affecting existing AIFs that have no leverage or redemption rights.

Financial market regulators in some EU member states have also expressed concern over the Directive in its current form. For example, in a speech at the FSA International Fund Forum in Monaco on June 24th, FSA Asset Management Sector Leader Dan Waters admitted that the scope and content of the Directive have been "a surprise and in many cases a complete shock to the markets that are affected."

Waters said that the FSA is particularly sceptical about the measures within the Directive that cover portfolio company disclosure, employee protections, tax reporting and short selling: "It strikes us as highly unusual to say the least to tackle issues with general market applicability through a directive targeted at the funds industry alone."

The question of outsourcing

The draft Directive also calls for AIFMs to gain permission from the regulator in their home member state in order to delegate administration – or indeed any other functions – to a third party. Given the recent Madoff events this appears an unusual stance to take – and indeed out of line with practices in many regulated markets where Administrators are themselves regulated. Where a regulated Administrator is to be appointed then this receives speedy regulatory approval – if other administrative solutions are being proposed then regulatory approval is required. Indeed, regulators should in fact be encouraging outsourcing to professional third parties, as LPs are demanding more and more, as independent scrutiny and expertise helps to safeguard the interests of all market participants.

What happens next?

During the coming months, the detail and scope of the draft Directive will continue to be hotly debated by AIF industry leaders, regulators and policy makers across Europe. Now is the time for Managers of AIFs of all kinds to make their voice heard, argues Waters: "It is important that practitioners and investors continue to engage with policy makers to ensure that regulatory changes are appropriate, proportionate and most importantly deliver the right outcomes for investors and for the wider financial system."

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