

# *Financial Services and Markets*

## *Fundamental change for the fund industry*

The European Commission has proposed a Directive on Alternative Investment Fund Managers. The purpose of this overview note is to summarise the proposal.

### **Proposed Directive**

The stated objective is "*to provide a clear and consistent framework for the regulation and supervision of managers of alternative investment funds in the EU*".

It will result in new European laws, once the European consultation and legislative procedures have been completed. In the UK, the Financial Services Authority will need to change its rules to reflect the new requirements.

In its current form the Directive has significant and unwelcome implications for the EU alternative investment fund management industry and for those who provide services to it. This includes private equity, real property, debt, commodity, infrastructure, film and hedge funds, as well as funds of funds and all other vehicles for collective investment which are not regulated UCITs funds. There will now be an intense period of lobbying and consultation and it is possible that some of the most undesirable aspects will change. If the proposal is modified so that its worst elements are removed then it has the potential to improve the environment for unregulated funds as it should significantly reduce the cost and legal uncertainty of cross-border marketing, but this nirvana is some way away.

The Commission proposes direct regulation of fund managers of all but the smallest funds, and, by regulating the manager, proposes to place indirect requirements on the funds. All managers will be subject to the same rules, with additional requirements for fund managers who use "high levels of leverage on a systematic basis" or whose funds acquire more than 30% of voting rights in investee companies.

There will be a transitional period, giving existing fund managers one year to comply after the Directive comes into force. In addition, where funds or functions are outside the EU, the non-EU jurisdictions have three years to meet EU standards. The Directive will contain detailed requirements, but there will also be further "implementing measures" in relation to most of the areas covered by the Directive. This is more detailed legislation, prepared once the form of the Directive is more certain, and which will contain more prescriptive detail as to the way in which requirements in the Directive are to be satisfied.

### **Why?**

The Proposal is a response to a range of different issues, some of which have been around for some time, but which have been given impetus by the recent financial turmoil and associated scandals. There are also political influences at work and, since the largest part of the alternative fund industry is London based, there are concerns that this is an attack on the City. It would, however, be a mistake to think this is only about hedge funds and private equity and is driven by just a few politicians.

There is a vast amount of lobbying to be done to make sure that the Directive does not do irreparable and unjustifiable harm to the alternative fund industry. Whilst the political case clearly has to be fought, this is not the only angle. The other concerns which are behind the legislation need to be recognised and the case made that the Directive proposals are not the right way to deal with them.

In this context key drivers for change include:

- the enormous political pressure placed on the Commission in relation to the activities of some hedge and private equity funds, in particular, in relation to short selling and leveraged investment in EU companies. The Rasmussen and Lehne reports which were adopted by the European Parliament last year were highly critical of the hedge fund and private equity industries;
- the impact of the Madoff affair, which should not be underestimated. Some EU countries have always been hostile to the marketing of non-EU funds, over which they feel they have no control, and the Madoff affair has given weight to their views. The fact that EU investors (including professional investors) were exposed to Madoff through funds based and/or marketed in the EU has clearly influenced the Commission, particularly in relation to investor protection issues such as marketing, custody and valuation of investments;

- the "credit crunch". Some funds were heavy sellers of investments in order to meet redemption requirements, which is thought to have had market impacts. Others had to suspend redemptions, affecting investors. Some hedge funds have suffered significant losses as a result of using investment techniques under which fund assets were transferred to Lehman in return for leverage;
- the current political and regulatory environment which is shaping a more hostile approach to "offshore financial centres";
- the complete lack of harmonisation across the EU in relation to the requirements for managing and marketing of unregulated funds. In recent years the Commission has been lobbied by industry to introduce a harmonised regime for the private placement of funds, and has convened various groups of experts to advise it on the single market implications of a patchwork of national securities marketing laws.

### High level summary

#### Scope

##### *Managers*

The Directive leaves considerable room for uncertainty over its precise scope: some provisions seem contradictory. In this note, we set out our current understanding of the draft, informed by the Commission's Impact Assessment and Frequently Asked Questions document. This is the beginning of a long process of negotiation and clarification.

The Directive regulates "alternative investment fund managers". The Commission indicates that this is because the responsibility for almost all decision-making in relation to the management of the fund lies with the manager. In this regard it refers not only to investment decisions but also the management of relations with investors and the organisation of administrative functions including valuation and safekeeping. Thus by "manager" the Commission seems to have in mind the entity with the direct responsibility to investors for the management and administration of the fund. In UK terminology, it is the fund "operator". There are many entities in the EU who have responsibility for the management of large parts of hedge and other fund portfolios, but who are not the "manager" of the fund in this wider sense.

Thus we consider that the current scope and impact of the draft is as follows.

##### *Exceptions*

The principal exceptions are for:

- managers where the fund portfolios under management (including assets acquired through use of leverage) do not in total exceed €500 million, provided that those funds are not leveraged and that investors have no redemption rights for five years;
- managers where the fund portfolios under management do not in total exceed €100 million (including assets acquired through use of leverage);
- managers who manage funds which are not "domiciled in the Community", provided that they do not market the funds in the EU.

Exempted managers have no rights under the Directive and cannot therefore use the passport to market their funds. They will be permitted to "opt in" so that they can have the passport, but they must then comply with the requirements of the Directive.

##### *EU-based managers*

The only entity in the EU permitted to manage and administer a fund is a manager whose head and registered office is in an EU Member State and who is authorised under the Directive, unless one of the limited exceptions applies. This is regardless of where the fund is established.

##### *Delegates of the principal fund manager/adviser/arrangers*

We believe that the effect of the current draft might be that a delegated fund manager and adviser/arranger will be outside the Directive. They will not be able to market the fund except as described below.

##### *Marketing interests in EU funds*

EU funds can only be marketed in EU Member States to professional investors if there is a fund manager authorised under the Directive, in which case they can be marketed: (a) by that manager; or (b) by a MiFID investment firm.

##### *Marketing interests in non-EU funds*

For the first three years after the Directive comes into force, a non-EU fund may continue to be marketed in an EU State if permitted by the laws of that EU State.

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After that, interests in a non-EU fund can be marketed to professional investors in all EU States:

- (a) by the EU authorised manager of that fund if the non-EU country in which the fund is domiciled has agreed to comply with OECD Standards on exchange of tax information;
- (b) by its fund manager established outside the EU if that manager obtains a special authorisation (see below);
- (c) by a MiFID investment firm if the fund is managed by a manager who falls within (b) or (c).

Member States will be able to authorise fund managers established in third countries (e.g. the US) to market funds in the EU. Such special authorisation can only be given if the Commission has decided that:

- the prudential regulation and on-going supervision of fund managers in the relevant country are equivalent to those under the Directive "and are effectively enforced";
- EU fund managers have effective and comparable market access in that country; and
- that country has agreed to comply with OECD Standards on exchange of tax information.

***The marketing passport/retail investors***

The Directive provides a passport for marketing funds to professional investors cross-border. Each Member State can decide if it permits marketing more widely and impose conditions if it does, there is no passport for marketing to retail investors. The passport can only be used by a manager authorised under the Directive. Prior notifications must be made.

**Capital requirements**

- Fund managers will be obliged to maintain a certain level of own funds. This is not a requirement to hold money in a bank account, though capital must be retained in the fund manager. Own funds essentially means "shareholder funds" after deducting any losses and intangible assets such as goodwill.
- The requirement is that own funds must be the higher of:
  - one quarter of fixed annual overheads; and
  - €125,000 plus 0.02% of the amount by which the value of the portfolios under management exceed €250 million.

**Appointment of independent valuer**

- All funds must have a valuer, independent of the manager, responsible for valuing fund assets and fund units.
- Three years after the Directive is implemented non-EU valuers will only be permitted if the Commission has determined that the valuation standards and rules in the relevant country are equivalent to those in the EU.

**Appointment of independent custodian**

- A separate custodian must be appointed which must be a bank with its registered office in the EU.
- If the fund is based outside the EU there must still be an EU custodian. Three years after implementation it will be permitted to delegate to a local sub-custodian only if the Commission has determined that the prudential regulation, supervision and standards of the country of the sub-custodian are equivalent to those imposed by the Directive.

**Delegation by the fund manager**

- The fund manager must obtain case-by-case permission from its regulator for each and every delegation of fund management, administration and marketing functions.
- Portfolio management or risk management can only be delegated to another fund manager authorised under the Directive. Three years after the Directive is implemented administrative functions will only be permitted to be delegated to a non-EU entity if it is authorised to provide administration services or registered in its own country and is subject to prudential supervision, and where there is a co-operation agreement with its regulator.

**Annual report**

- An annual report on each fund must be made available to investors and regulators within four months of the end of the financial year. The report must include a statement of assets and liabilities, a detailed income and expenditure account and a report on activities, and the accounting information must be audited by an EU auditor (even where the fund is non-EU).

**Disclosure to investors**

- The manager must provide investors with certain information prior to their investment into the fund and update the information if it changes. This includes identifying investors who have rights to obtain "preferential treatment", e.g. through side letters, and describing the nature of that preferential treatment.

**Reporting to competent authorities**

- The manager must report a considerable amount of information to its regulator including as to its trading and short selling activity. (The Turner Review, which analysed the causes of the financial crisis and suggested the way forward, identified a need for regulators to have more extensive information on hedge fund activities and on the activities of any other emerging form of investment intermediation, in order to inform their macro-prudential analysis.)

**Conduct of business**

Managers will be required to:

- act in the best interests of the fund, the investors in the fund and the integrity of the market and ensure that all investors are treated fairly;
- identify conflicts of interest between the manager and investors and between one investor and another, and manage and disclose conflicts;
- separate tasks and responsibilities for risk management and for portfolio management;
- implement risk management systems to monitor the risks associated with each fund investment strategy;
- follow a documented due diligence process for investment;
- adopt an appropriate liquidity management system to ensure that the liquidity profile of investments complies with its obligations and ensure the fund has a formal redemption policy appropriate to the liquidity profile of the fund investments. The Commission will adopt minimum liquidity requirements for funds which permit investor redemption more frequently than half-yearly.

**Use of leverage**

- A manager is required to notify its regulator if a fund it manages employs "high levels of leverage on a systematic basis". This is when the combined leverage from all sources exceeds the value of the equity capital of the fund on two out of the past four quarters.
- "Leverage" is defined as "any method by which the manager increases the exposure of a fund it manages to a particular investment whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means". These provisions appear to be directed at debt and hedge funds where the fund is a direct borrower. It is not thought that transactions where the leverage is at investee level are intended to be caught, although this is not clear.
- Fund managers who fall within these provisions are required to make certain disclosures in relation to each relevant fund to its investors and to its regulator.
- The regulator is required to aggregate the information it receives in respect of all the managers that it supervises and make it available to other EU regulators. It is also required to notify other regulators if a manager under its supervision could constitute an important source of counterparty risk to a bank or other systemically relevant institution in another EU State.
- The Commission will set a limit on the level of leverage fund managers can employ.

**Obligations for managers who have controlling influence in companies**

- If a fund manager manages one or more funds which either individually or in aggregate account for 30% or more of the voting rights of a listed or non-listed company domiciled in the EU, or has an agreement with other managers which would allow the funds managed by them in aggregate to acquire 30% or more, then it is subject to a range of disclosure requirements.
- The only exception is for investees which employ fewer than 250 people, have an annual turnover not exceeding €50 million and/or an annual balance sheet total not exceeding €43 million.
- The manager must provide certain information to a listed company, its shareholders and employee representatives, including its policy for preventing and managing conflicts of interest, in particular between the fund manager and the company and its policy for about how it communicates with stakeholders, in particular about issues affecting its employees.
- The manager must provide certain information to unlisted companies and their shareholders and employee representatives including the development plan for the company, its policy for preventing and managing conflicts, in particular between the fund manager and the company, and its policy about how it communicates with stakeholders, in particular about issues affecting its employees.
- Where there is no employee representative, for both listed and unlisted companies the relevant information must be provided to all employees.

**Public to private transactions**

- An issuer which is delisted must continue to fulfil certain requirements relating to annual and half yearly public accounts for a listed company for two complete financial years following its withdrawal from the regulated market.
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**Naked short selling**

- A manager who short sells on behalf of a fund is required to have procedures which enable it to access the securities on the settlement date and have risk management procedures designed to manage the risks associated with short selling.

**Investing in Securitised Investments**

- An alternative investment fund will only be able to invest in securitisations if the originator has retained at least a 5 per cent net economic interest, and risk management and due diligence requirements are met.

**Comment**

There are so many criticisms that can be made of the proposal that a book would be needed to do them justice. It has the potential to be Europe's Sarbanes-Oxley, driving investment and jobs out of Europe. Criticisms include:

- The significant costs which will be imposed (which will be borne largely by investors). In particular, the requirements for independent custodians and valuers are disproportionate, costly and impractical and will involve significant disruption to existing arrangements. In some areas such as private equity the imposition of the "independent valuer" will result in the replacement of the person who does understand the investment with someone who does not. This will not improve investor protection, because in a closed-ended fund, the investor does not get any "value" until investments are actually realised, at which point their value is clear.
- The proposals do not fit with the commercial and practical realities of marketing and operating different types of fund.
- The transitional issues are huge. The Directive would affect existing funds under management as well as funds raised after it comes into force. The terms of these funds have been negotiated with investors and some of the issues may well require changes to existing arrangements which will need to be contractually agreed.
- The proposed capital requirements may, if implemented, bring about the closure or merger of many existing fund managers and would be a significant deterrent to new entrants and therefore to competition.
- It will have a distorting effect on the competitiveness of private equity backed companies, whose strategies and business plans will be public, whilst those of their competitors will not be.
- There are a number of provisions which will be onerous for regulators as well as firms and which give rise to reputational risk for the regulator. In the UK, the FSA would be deluged with requests for approvals of delegation and marketing.

Meanwhile sovereign wealth funds, oligarchs and other investors will be permitted to operate from within the EU and invest in anything, no matter how large a company or how politically sensitive the investment, without any requirement as to transparency as to their ownership or intentions and with no restriction on their leverage.

If you would like further information or advice on these matters, please contact Margaret Chamberlain, Jane Tuckley or Tim Lewis in the Financial Services and Markets Department or your usual contact at Travers Smith.

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