

AIFM Analysis

The draft AIFM Directive Some reflections from a Luxembourg perspective October 2009

The EU Commission published a first draft of a Directive on Alternative Investment Fund Managers on 30 April 2009. The draft has provoked much controversy, not just within the industry sector, but also in the political environment of several major EU countries. This review seeks to make a measured analysis of the proposals, and examines their likely major implications from a Luxembourg perspective were the Directive to be effected in its current draft form. There are however growing signs that this may not be the case as a revised draft, as amended by the Swedish EU Presidency, is expected to be published very soon, and intense lobbying and debate is continuing. Future editions of this AIFM Analysis will track the many likely changes and compromises in approach that are anticipated.

Why? And who?

The draft Directive itself says it “forms part of an ambitious European Commission programme to extend appropriate regulation to all actions and activities that embed significant risks”. The explanatory memorandum prefacing the draft Directive goes on to argue that “the individual and collective activities of large alternative investment fund managers, particularly those employing high levels of leverage, amplify market movements and have contributed to the ongoing instability of financial markets across the European Union. Yet there are currently no effective mechanisms for gathering, pooling and analysing information on these risks at European level”. It also expresses concern over the quality of the risk management by fund managers, nothing that investors, creditors and trading counterparties of funds each depend on controls implemented by the fund manager, and that EU jurisdictions currently differ widely in the way that they supervise the ongoing operations of fund managers.

The authors of the draft Directive recognise that fund managers were **not** the cause of the current financial crisis, but believe that some types of fund management activity have caused increased stress in the financial system as a whole – notably hedge funds causing asset price inflation and the rapid growth of structured credit markets. The financial crisis has also undeniably highlighted the risks that funds are exposed to, and the draft Directive's authors point out both the way in which some hedge funds have had to unwind large leveraged positions, and the difficulties many private equity funds now face in the lack of availabilities of credit and the financial health of their portfolio companies.

The solution sought by the draft Directive is broad – it does not just focus on hedge funds and private equity fund managers. The European Commission believes that “it would be ineffective and short-sighted to limit any legislative initiative to these two categories of fund manager; ineffective because any arbitrary definition of these funds might not adequately capture all the relevant actors and could be easily circumvented; and short-

sighted because many of the underlying risks are also present in other types of fund manager activity. The regulatory solution which is likely to prove the most enduring and productive is therefore to capture all fund managers whose activities give rise to those risks. Accordingly, the management and administration of **any non-UCITS** in the European Union **must be authorised and supervised** in accordance with the requirements of the Directive.”

Looking in more detail at **who** is subject to the draft Directive, the first key point to note is that it is the **fund manager**, not the fund itself, which **is to be regulated**. Any fund manager wishing to **operate** in the European Union is to be subject to the draft Directive's authorisation and supervisory regime. This will apply irrespective of the legal domicile of the fund being managed.

The fund manager must have prior authorisation, from the regulator in the EU state where the fund manager is established, before it can provide management services – such services are defined as the activities of **managing and administering** one or more funds on behalf of one or more investors.

The draft Directive links the provision of management services with the marketing of shares or units in funds. The draft Directive provide that a fund manager that is authorised to provide management services to a fund is also entitled to market that fund's shares or units to “professional” investors (as defined in the MiFID Directive). Conversely, Member States are required by the draft Directive **only** provides management services, or markets shares or units, once prior authorisation has been given. The implications of the draft Directive extending to regulate all marketing activity is looked at further below when considering the position of non-EU domiciled funds.

Furthermore, from reading the draft Directive one interpretation is that **any entity not authorised under the draft Directive may neither provide management services, nor market any fund's units or shares, anywhere within the EU**.

Fund managers **already operating** in the EU before the Directive takes effect will need to take steps to comply with the Directive, and **apply** for authorisation under the Directive, within **one year** of the deadline for EU states to implement the Directive.

There are some let-outs for certain types of fund managers

- Fund managers who, when aggregated with other companies under common control, have assets under management of not more than EUR 100 million in total in funds that they manage (the limit is EUR 500 million if the portfolio of funds managed only involves non-leveraged funds whose investors are locked in for at least five years after the fund is set up);
- “UCITS” – funds aimed at the retail market and already subject to heavy EU Directive-mandated regulation – and their management or investment companies;
- Credit institutions that are already fully regulated as banks under EU Directives.

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Turning to the forms of funds falling within the scope of the Directive, this too is very broad, and it is important to realise that fund managers involved not only with types of fund vehicles that are currently not regulated, but also with many types of fund vehicle that are **already subject to regulation**, will be in scope. The draft Directive defines the alternative investment fund the management of which falls within its ambit as being “any collective investment undertaking... whose objective is the collective investment in assets” and which is not authorised under the UCITS Directive.

From a Luxembourg perspective this means that any fund manager that manages or markets an FCP or SICAV already regulated under the 2007 SIF regime – or a SICAR under the 2004 regime – is within the scope of the draft Directive. Furthermore, even “Part II” retail-type funds – those not qualifying for the UCITS regime - are also caught. The only let-out would be for the fund manager also already to be a management company or investment company of a UCITS FCP, SICAV or other fund with UCITS status.

Looking more broadly, any manager (including a general partner of a UK limited partnership - the fund vehicle of choice for many fund structures that use Luxembourg as a platform for real estate or private equity holding or hedge fund activities) is clearly within the scope of the Directive, and thus meaning that regulation beyond that with the lightest of touches will affect this type of fund vehicle for the first time. Also within scope are the managers of German “*spezial fonds*”, closed ended funds, and even public open ended funds – all major players in the German real estate funds sector.

The non-EU dimension

Fund managers domiciled outside the EU are to be **precluded** by the draft Directive **from** carrying out any **fund management activity** (including administration) in the EU, unless they “establish” themselves in the EU – presumably by formally setting up a branch with a registered office in the EU. Once “established”, the fund manager would have the same obligations to obtain authorisation (from the regulator in the state where the branch has its registered office) to operate, and otherwise to comply with the Directive, as an EU-domiciled fund manager. Non-EU fund management groups who set up subsidiary companies domiciled in the EU to act as fund managers within the EU will of course anyway see those subsidiary companies fall fully within the scope of the draft Directive.

However, the draft Directive explicitly requires regulators to **refuse** authorisation in any situation where legislation or regulation in the country where the fund manager’s head office is set up (or in any other country where the owners or controllers of the fund manager are based) would prevent, or make it difficult for the EU regulator to exercise its supervisory function.

Looking beyond management activity, the draft Directive foresees that all other provisions relating to the non-EU dimension can only come into effect **three years after** the deadline for EU states to implement the Directive.

This three year “transition” period is perhaps one of the most contentious aspects of the draft Directive, which notes in its Explanatory Memorandum that this is necessary because of the “time needed to provide for additional requirements in implementing measures”. In the meantime, the draft Directive provides – and the Explanatory Memorandum confirms – that fund managers who are authorised to operate in the EU may continue to market non-EU domiciled funds to professional investors in the fund manager’s own state within the EU subject to that state’s own laws.

Conversely, the position of fund managers not established in the EU does not allow the status quo to carry over – **non-EU fund managers will not be able to market any funds within the EU for this three year period**. The only ways to seek to deal with this barrier will be either to “establish” in the EU and comply with the Directive, or to rely on an approach that “private placement” arrangements are an activity not sufficiently broad to be regarded as “marketing”. This potential “shutting out” for a three year period of non-EU fund managers wishing to market in the EU is a particularly controversial aspect, which some parties have flagged as protectionist in spirit. That said, if non-EU fund managers based in say Switzerland or the US can continue to attract investors using “private placement” arrangements, this would instead put them at an advantage to EU-based fund managers, as the non-EU fund manager would have a cost and absence of regulation benefit.

Once the three year transition period has passed, the position regarding marketing activity will then be as follows.

Fund managers not established in the EU will then at least potentially be **able to market funds** (both EU domiciled and others) to professional investors across the EU, under the same regulatory framework as EU-based fund managers, by obtaining authorisation from an EU state’s regulator. However, under the draft Directive, before this can happen, it will be necessary for the EU Commission to confirm that the jurisdiction where the fund manager is established (and not the fund manager itself) has fulfilled strict conditions, notably concerning the existence of

- a regulatory regime equivalent to that of the Directive;
- equivalent access for EU fund managers to that jurisdiction’s market;
- co-operation agreements between the two relevant regulators;
- a double tax treaty between the two relevant jurisdictions, having an appropriate exchange of information clause.

In practice, these provisions may arguably still be seen to have a protectionist effect, given the high bar set by these conditions and the level of direct involvement of the EU Commission. Indeed, it has been said that these provisions in particular could act as a spur for retaliatory action by other jurisdictions.

Authorised **EU fund managers** will then be able to market **non-EU domiciled funds** within the framework of the Directive, but only so long as the fund which it is intended to be marketed is domiciled in a jurisdiction which has signed a double tax treaty having an appropriate exchange of information clause.

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A consequence of this provision, taken together with the general ban under the draft Directive on non-authorised fund managers undertaking any marketing activity anywhere in the EU, would be that **funds** that are domiciled in jurisdictions that continue to retain **tax haven** attributes (for example, potentially the Cayman Islands) **could not be marketed to any EU investors** once the three year extension to the status quo has ended.

On this basis, if it appears that the draft Directive is going to be implemented in its current form in this area, there would be an incentive for fund sponsors to set up new funds using a fund vehicle domiciled in the EU. Alternatively, fund sponsors might look to use EU-domiciled feeders into non-EU main fund vehicles, or to set up “mirror” EU-domiciled funds, to target EU investors. This would be an advantage for Luxembourg, or other EU states that offer an environment favourable for fund vehicles.

Conversely, non-EU fund sponsors may simply choose to not market funds to EU investors – thereby “excommunicating” EU investors by depriving them of choice in allocating to investments.

What does being regulated mean?

- In applying for authorisation as a fund manager, details of the ownership of the fund manager, how it intends to comply with the various obligations of the draft Directive described below, and the sort of funds it plans to manage, will need to be provided to the regulator of the home state of the fund manager. The regulator will then have two months to either authorise the fund manager or reject its application.
- The initial **authorisation** as a fund manager will by itself permit a fund manager **to provide management services** to funds domiciled in the home state of the fund manager – no further specific authorisation will be required. If funds domiciled in other EU states are to be managed, the fund manager will initially need to tell its home state regulator of its plans – these will need to be sent by that regulator, within ten days, to the regulator in the state where the management services are to be provided, with a confirmation that the fund manager is authorised. The home state regulator must then immediately tell the fund manager that it has forwarded the information to its counterparty, and the fund manager can commence operation henceforth in the other EU state without further ado as soon as notification of this transmittal is received.
- The provision of **marketing services** is more closely controlled, even to “professional investors”. (Regulators can permit fund managers authorised under this draft Directive to also market to retail investors, but may impose stricter requirements.) **For each fund** that a manager is authorised to manage and for which marketing activity is planned in the home state of the fund manager, a **separate notification** must be given to the regulator – the regulator then has ten days to confirm whether or not marketing may be commenced, and under what conditions.

- If marketing activity is planned for other member states, then a process similar to that for providing management services is involved. The fund manager will initially need to tell its home state regulator of its plans, and the funds concerned, by way of a detailed notification – this will need to be sent by that regulator, within ten days, to the regulator in the state where the marketing activity is to be undertaken, with a confirmation that the fund manager is authorised. The home state regulator must then immediately tell the fund manager that it has forwarded the information to its counterparty, and the fund manager can commence marketing henceforth in the other EU state without further ado as soon as notification of this transmittal is received.
- The fund manager must have a **minimum own capital of EUR 125,000** – or of 2 bps of the value of the portfolio it manages, if this is over EUR 250 million.
- Fund managers may **delegate** functions, such as administration, subject to approval of the service provider concerned (which cannot also be the “depository” or “valuator”, each as described below) by the regulator in the service provider’s jurisdiction. In order to undertake portfolio management or risk management, a service provider must itself be authorised as if it were directly performing fund management services to the fund concerned i.e. as AIFM. Sub-delegation is not permitted, and the fund manager remains fully liable for acts of service providers to which functions are delegated.

Delegation to non-EU service providers is only permitted if the service provider is subject to local regulation, and the regulator has a co-operation agreement with the fund manager’s regulator.

- For each fund managed a “**valuator**”, independent from the fund manager and administrator, will have to be appointed and will have to carry out annual valuations. Furthermore every time shares or units are issued, or redeemed, by a fund, a valuation will also be required. The valuator will have on each occasion to value all the underlying assets of the fund, as well as valuing the shares or units. Valuations will need to be made applying rules set out in the fund’s constituting documents, or under local GAAP.
- Also, for each fund managed, a “**depository**” must be appointed. This depository – in effect, a custodian – must be an authorised EU credit institution. The depository must
 - take in all funds subscribed by investors;
 - safe-keep fund financial instruments; and
 - verify that the fund actually owns all other assets the fund invests in.

The depository will be liable both to the fund and the fund manager for any losses either suffers due to the depository not performing its duties.

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For non-EU domiciled funds, the requirement to have an authorised EU credit institution remains. However in this situation, the depositary may appoint a sub-depositary domiciled in the same (non-EU) jurisdiction as the fund, so long as that jurisdiction has EU-equivalent legislation covering the activities of depositaries.

This requirement for an EU bank to act as depositary would be a major new obligation for fund managers of currently non-regulated funds, and would be particularly burdensome and costly for very many real estate and private equity funds. Hedge funds also face particular issues, as it is thought that currently very few prime brokers are EU credit institutions.

In particular, the explicit provision regarding the depositary's liability would appear to be a response to the Madoff scandal. The whole aspect of the level of involvement of a depositary is perhaps one of the most difficult and contentious areas of the draft Directive, and much ongoing discussion is likely to centre on this until a final approach is decided.

- Fund managers will have the way in which they conduct their **business operations** tightly regulated – the draft Directive expects the EU Commission in due course to bring in supplementary implementing regulations (as yet undrafted) dealing with many of these aspects. As well as imposing broad obligations to ensure that investors are treated fairly, and not preferentially unless this is disclosed in the fund's rules or constituting documents, explicit processes will need to be in place covering
 - conflicts of interest;
 - separation of risk management and portfolio management activities;
 - due diligence processes;
 - accurate identification, measurement and monitoring of risks, via "stress testing" procedures;
 - short selling;
 - liquidity management and redemption policies;
 - investment in securitisations.
- **Investor reporting and disclosure** requirements – notably the need to have audited annual reports with investors and regulators no later than four months after the year end, and the scope of information to be given to potential investors. The requirements are outlined in the draft Directive, but supplementary implementing regulations (as yet undrafted) are also foreseen. Additionally, funds with "high levels" of leverage – defined as a fund having more debt than investor equity – will have to disclose total leverage to investors each quarter.

Again the draft Directive presages a move from the status quo – where disclosure is driven by what is seen in the market as necessary or attractive to bring in investors, and is largely driven by contractual commitment to investors – to a much more formal "one size fits all" regulatory framework tending towards that most appropriate to a retail investor base.

The four month deadline for audited accounts will involve a sharp acceleration of post year-end processes for many funds.

The use of a 1:1 or 50% LTV debt equity ratio to define "high levels" of leverage may be particularly constricting, as until now such levels of gearing have been commonplace in real estate and private equity funds, and very much the norm in hedge funds.

- **Regulatory reporting** – to the fund manager's home EU state regulator – is also foreseen. The obligations will cover disclosing details of illiquid assets and steps taken to manage such positions, of risk profiles and risk management tools in use, and of short selling undertaken. Funds with "high levels" of leverage will have additional reporting commitments. Again, supplementary implementing regulations (as yet undrafted) are foreseen.

This type of reporting may have importance and relevance in the hedge fund sector, but will be purely an additional disclosure burden for funds in the real estate and private equity sectors, the majority of whose investments are almost by definition illiquid.

- In situations where funds own **30% or more of a non-listed company**, further detailed provisions are made.

What will the regulators have to do?

Each EU state regulator will have broad powers to grant and withdraw authorisations to fund managers, to supervise and regulate, and obligations to collaborate with regulators in other EU states.

Additionally, regulators will be obliged to use information gathered from the reporting by fund managers of leveraging. The objective will be to identify "the extent to which the use of leverage contributes to the build up of systemic risk in the financial system or risks of disorderly markets". Regulators must also share information with each other on individual fund managers that could potentially constitute an important source of counterparty risk.

This "macro-economic" responsibility is also assumed by the Commission itself, which the draft Directive empowers to set absolute limits, by fund type, on the levels of leverage fund managers can apply. Furthermore, in exceptional circumstances, regulators themselves can impose additional limits.

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Timing and conclusions

As it is highly unlikely that the political approval of the Commission's proposals is reached before the end of 2009, the Directive will probably not come into force before 2012. However, if the draft Directive is implemented even substantially in its current form, then all funds and their managers that are affected by the Directive will need to recognise that the new regime will have a major effect on how they operate, and on their cost base.

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