

European Directive on Alternative Investment Fund Managers

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On April 29, 2009, the European Commission submitted a new proposal of Directive on Alternative Investment Fund Managers (“AIFM”) to the European Parliament and to the Council. After lots of intense debates on the potential roles and responsibilities of hedge funds and private equity funds in the financial crisis, the enhancement of their regulatory and supervisory framework is no longer a topic for discussion but a reality.

Under this proposed Directive, European investment managers of non-UCITS investment funds will have to comply with a common set of rules in terms of licensing and supervision. In return, non-UCITS funds that they manage – designated in the Directive as Alternative Investment Funds (“AIF”) – will benefit from a European passport for cross-border distribution to EU professional investors.

We do not know at this stage the timeframe for finalisation, voting and implementation; but considering the importance of this regulation for the Luxembourg fund industry, stakeholders should sit down now and analyse the document in detail so that comments are issued soon enough in the process and taken into account.

Key points in the proposed Directive

Scope

All European legal or natural persons (excluding credit institutions) whose regular activities are to manage¹ one or several AIF irrespective of their type (open-ended vs closed-ended), their legal structure and their country of domicile (even outside the EU) would fall in the scope of this proposed Directive provided that the assets under their management exceed a threshold of EUR 100 M².

The concept of AIF should be understood broadly: AIF are all collective investment undertakings, whatever their legal form, which are not authorised pursuant to Directive 85/611/EEC on UCITS. Luxembourg Part II funds and SIF are AIF. AIF may be EU or non-EU funds (e.g. Cayman funds) provided however that an OECD Model Tax Convention compliant agreement is signed between the Member State of the AIF and the third country in order to ensure an effective exchange of tax information.

¹ Management services include activities of managing, administering and marketing one or more AIF on behalf of one or more investors.

² or EUR 500 M when the AIF under management are not leveraged and with no redemption rights exercisable during a period of 5 years following their respective date of constitution.

Operating conditions

AIFM should have an initial capital of at least EUR 125,000 and provide an additional amount of own funds equal to 0.02% of the amount by which the value of the portfolios under management exceeds EUR 250 M³.

On top of the adequacy of human and technical means that are necessary for the proper performance of their management activities, code of business and conflict of interest procedures, the AIFM would have to:

- entrust a legally and functionally independent valuator with the valuation of the assets of the AIF under management (the frequency of which being at least yearly), as well as the valuation of their shares or units;
- implement functionally independent risk management processes;
- appropriately manage the liquidity of the AIF under management;
- delegate its portfolio management or risk management functions to other AIFM only. The other functions could be delegated to third parties established in other Member States or even outside the EU. No possibility to sub-delegate any of the AIFM's functions should be allowed.

To avoid inefficiencies and potential duplication of management companies, the proposed Directive offers the possibility for an AIFM to be authorised by the competent authorities to also act as a management company of UCITS under the meaning of Directive 85/611/EEC.

Depositary requirements

The Depositary of the AIF must be independent from the AIFM and must be a credit institution having its registered office in an EU Member State.

Transparency requirements

In order to protect investors, specific information would have to be communicated before investment including a description of the valuation procedures and the liquidity risk management. In addition, the percentage of illiquid, hard-to-value or side-pocketed assets, as well as the updated risk profile and potential new arrangements made for managing liquidity risks would have to be periodically disclosed.

Comparable information would have to be periodically reported to the home state regulator.

Recognition of a European passport

Once approved by its home state regulator, the AIFM would be free to provide management services directly to an AIF domiciled in another EU Member State or by establishing a branch.

In addition, the AIFM could market the AIF it manages (including potentially non European AIF) in another EU Member State but to professional investors⁴ only. Retail cross-border marketing of units or shares of AIF should not be authorised by the European regulators.

³ And should never be less than an amount equal to 25% of their fixed overheads.

⁴ "Professional investors" means any investor within the meaning set out in MiFID (Directive 2004/39/EC).

At the domestic level, each Member State remains however free to authorise the distribution of AIF managed by an AIFM to retail investors on its territory and potentially impose additional related requirements.

However, the European passport to market non-European AIF should only enter into force three years after the transposition date of the Directive.

Specific obligations regarding AIFM managing specific types of AIF

The proposed Directive imposes specific requirements to AIFM managing leveraged AIF or AIF which acquire controlling influence in companies.

Key challenges for Luxembourg: a different approach

The proposed Directive focuses on regulating AIFM rather than AIF. This approach is not the same as the one adopted in Luxembourg, where non-UCITS funds (the so-called Part II funds and SIF) must be regulated entities – meaning that they are authorised and supervised on an ongoing basis by the Luxembourg regulatory authority - and where their management companies are submitted to no or light supervision.

The chart below compares (and is not exhaustive) the regulatory framework for non-UCITS as it is currently laid down in the proposed Directive versus the one currently applicable in Luxembourg to non-UCITS funds:

	Luxembourg Law on Part II funds	Luxembourg Law on SIF	Proposed Directive ⁵
Requirement for prudential supervision of the fund	Yes	Yes	No ⁶
The fund custodian must be in the fund domicile	Yes	Yes	No
The fund valuator (in charge of NAV calculation and valuation of the fund's assets) must be:			
- in the fund domicile	Yes	Yes	No
- independent from the management company	No	No	Yes
The fund must have a regulated management company	Only required for FCP	Only required for FCP	Yes

⁵ The fourth column describes some requirements applicable to AIF managed by an AIFM (and thus benefitting from an EU passport for distribution to professional investors), as laid down in the proposed Directive. Note that Part II Funds and SIF, provided that they appoint an AIFM and comply with these (and other) requirements, would logically also benefit from that passport under the proposed Directive.

⁶ Cayman and other offshore non-regulated funds could benefit from the passport for distribution to professional investors in the EU provided that they comply with the requirements in the proposed Directive (including appointment of an EU based AIFM).

The differences highlighted in the table are extremely important and require careful analysis in order to avoid bad surprises (inadequacy of the Luxembourg regulatory framework for non-UCITS) in a few years when the proposed Directive is implemented.

However, the industry is widely criticising the political pressure around hedge funds and private equity funds, as well as the lack of consultation during the drafting of this proposed Directive. They consider it disproportionate, incomplete and inappropriate to the alternative fund business. Thus, political discussions and negotiations are expected in the coming months. This might lead to significant modifications and to a delay in enforcing the proposed Directive.

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