

Europe's Alternative Investment Fund Managers Directive poses more questions than it provides answers

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If the EU enacts the Directive in its current form, it may impose a disproportionate regulatory regime on managers of alternatives funds that are not authorised UCITS.



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On 1 May, 2009, the European Union published its draft directive on Alternative Investment Fund Managers ("AIFM"), (the "Directive"). The Directive, as drafted, will radically reshape the alternative asset management industry in the EU, potentially requiring changes to AIFMs' business models and significantly increasing the regulatory demands on AIFMs, including increased capital, disclosure, risk management and liquidity measures, reporting and other costs. The Directive also poses a number of questions about the accessibility of the EU's markets to non-EU alternative fund managers and funds and how EU-based managers with funds or connections outside the EU are going to be able to continue to operate. In addition, the Directive has important implications for administrators, valuers, depositories, prime brokers and custodians and other service providers to AIF.

The AIFM is the EU's response to comments in the G20 Communiqué, which referred to the need for certain systemically important hedge funds to be regulated, and for financial regulators to have access to information necessary for the assessment of systemic risks and the tools necessary for effective macro-economic oversight. Macro-prudential risks associated with the use of leverage primarily relate to the activities of hedge funds, however, the Directive goes further, proposing the creation of a comprehensive regulatory environment for all alternative investment fund managers, including those managing private equity, commodity, real estate and infrastructure funds. The Directive not only addresses systemic risk but also, with a key focus on micro-prudential issues and risks associated with inadequate governance arrangements, has a key objective of ensuring a high level of consumer and investor protection. This will be achieved by specifying a detailed common framework for the authorisation and supervision of AIFM.

It could well be argued that this level of consumer protection goes beyond what is actually required by the Professional/Qualified investors, who will be the only categories of investor to whom participations in AIFs will be able to be sold. It may also prove expensive not only for the AIFM, who may well have to adopt costly policies and procedures to satisfy the Directive's requirements, but also indirectly for those investors to whom it is likely AIFMs will seek to transfer those costs by recharging the AIF.

Applying to a wide range of alternatives managers

The Directive affects the managers of hedge funds, private equity funds, real estate funds and infrastructure funds, as well as REITs, listed investment trusts and many other forms of collective investment vehicle which have previously been outside the scope of financial services regulation. AIFM that are divisions of EU banks or insurers, or are authorised pension fund managers and various categories of sovereign wealth funds, however, are excluded from the scope of the Directive, putting those institutions at a relative competitive advantage.

Fund managers established outside the EU will be able to seek authorisation from a member state in order to market shares or units in any AIF in the EU, subject both to themselves and the jurisdictions in which they are based meeting certain stringent conditions.

The Directive, as drafted, will apply to all AIFM with assets under management in excess of €100m, irrespective of the number of AIF managed or the nature of those assets. It is unclear if this is net or gross assets but the definition does include assets “acquired through the use of leverage”. AIF with assets up to €500m under management that do not use leverage and prohibit investor redemptions for five years from subscription are excluded (which may provide a significant competitive advantage to Shariah compliant AIF and other unleveraged AIF). The Directive is deliberately not sector specific. For example, as the thresholds are arrived at by the aggregation of all funds under management (rather than on a per fund basis), real estate funds which are managed professionally are likely to come within its scope, although the systemic risk of such funds is questionable.

Fund managers established outside the EU will be able to seek authorisation from a member state in order to market shares or units in any AIF in the EU, subject both to themselves and the jurisdictions in which they are based meeting certain stringent conditions. These include determinations by the EU Commission as to equivalence of the law and regulatory supervision in non-EU member countries with laws and supervision in the EU, and the existence of effective information sharing agreements on tax matters in accordance with the standards laid down in Article 26 of the OECD Model Tax Convention.

A disproportionate regulatory regime?

The Directive has the potential to be beneficial. There will be merits to a uniform platform of regulation and, certainly, a passport for funds and their managers in the AIF industry will be an advantage. However, if enacted in its current form, the Directive risks imposing a disproportionate regulatory regime on the managers of all collective investment vehicles which are non-qualifying UCITs and which are intended only to be available to sophisticated investors, as well as seeking to achieve tax-related objectives which are inappropriate for a Directive intended to provide a framework for regulating managers. It also leaves the position of established funds that are already fully invested unclear.

The time for consultation on the Directive is likely to be very short. The draft will now be sent to the European Parliament and European Council, where the Commission expects it to be the object of intense political discussion and negotiation. If political approval on the Commission’s proposals is reached by the end of 2009, the Directive could come into force in 2011.

It is crucial that industry participants assess the potential impact of the proposed Directive immediately and act now, so that they can seek to influence the shape of the final Directive and its implementing regulations, and, to the extent necessary, start planning for the changes the Directive will require.

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