

Regulatory changes in the US and the EU directive

by Stefanie Neches and Andrew Thorne

On Wednesday, June 17, 2009, the Obama administration released its plan for financial regulatory reform built around five key proposals. The first of these proposals to “promote robust supervision and regulation” of financial firms was designed by the administration to correct the “gaps and weaknesses” that were perceived to exist in the regulatory system. These gaps and weaknesses were highlighted by a number of high-profile frauds and a perception that a lack of transparency into the financial dealings of private investment funds posed an unknown threat to the overall economic financial stability. Embedded in their plan, therefore, was a proposal that would require the registration of advisers to hedge funds and other private investment funds. On July 15, the Obama administration, following on the heels of the earlier broad proposal sent to Congress, proposed legislation under the Private Fund Investment Advisers Registration Act of 2009 requiring the registration of nearly all investment advisers to private investment pools (hedge funds, private equity funds, venture capital funds).

Across the Atlantic a few months earlier, on April 30, the European Commission proposed its own changes to its alternative investment industry when it issued the European Directive on Alternative Investment Fund Managers (AIFM). Like the Obama administration’s plan, the aim of the directive was to bring regulatory reform to AIFM through a series of far-reaching proposals. Given the potential for far-reaching implications, it is important that advisers begin to pay careful attention to both the proposed US legislation and the European Commission directive, particularly if their current or future plans are to expand the investor base to residents of the European Union (EU).

Proposed US hedge fund registration

Under the draft Obama administration legislation, advisers to hedge funds and other private investment funds with more than \$30 million under management (i.e., nearly all AIFMs located or doing business in the United States) will have to register with the Securities and Exchange Commission (SEC), with smaller advisers registering and becoming regulated by individual states. Once registered with the SEC, investment advisers to private funds will be subject to requirements that will require not only additional oversight, but also significant investment in meeting the reporting and compliance requirements of registration. Managers already registered should take note because the proposal will require greater reporting requirements than are currently contemplated in the existing rules if passed.

For example, advisers will be required to report confidentially to the SEC (and indirectly to the Federal Reserve and the Financial Services Oversight Council) the amount of assets under management, borrowings, off-balance-sheet exposures, counterparty credit risk exposures, trading and investment positions, and other important information relevant to determining potential systemic risk and potential threats to our overall financial stability. Reporting to investors, creditors, and counterparties will also be required.

Based on the proposals from the Obama administration, the SEC would also share required nonpublic disclosures with the Federal Reserve and the Financial Services Oversight Council. This information, the regulators believe, will help determine whether systemic risk exists among private funds. While not written specifically to capture private funds or their advisers, such reporting could possibly result in advisers or private funds meeting the standard of a Tier 1 financial holding company as

described in the regulatory reform proposals. While the definition and the regulatory oversight mechanism specific to Tier 1 financial holding companies has not yet been established, it is expected that these entities will be subject to stricter requirements concerning capital, liquidity, and risk management standards than other financial firms.

These new proposals will impact US and foreign advisers alike. Within the rules' changes is the proposal that "foreign private advisers" would be exempt from registration. A "foreign private adviser" is defined as any adviser that has no place of business in the United States, does not hold itself out in the United States as an investment adviser, and during the preceding 12 months has had fewer than 15 US clients and less than \$25 million in assets under management attributable to clients in the United States. This is a very narrow exemption, which most foreign AIFMs with US investors will have difficulty meeting.

Finally, regardless of whether an adviser will be required to be registered or is already registered, the SEC has proposed rule changes requiring that advisers deemed to have custody over their clients assets will be required to engage an independent audit firm to conduct an annual surprise verification of assets. This verification will be required regardless of whether a qualified custodian provides statements to investors or the private investment funds issue financial statements annually. It is expected that most advisers of private investment funds will be deemed to have custody over client assets and will therefore be required to have the verification performed.

Registration will require that advisers establish a comprehensive compliance program with strong conflict-of-interest and anti-fraud prohibitions. Advisers should be prepared to undergo regular SEC examinations to monitor compliance and assess potential risk.

The European directive

US managers should also spend time understanding the impact of the EU directive. While it is expected that the earliest effective date will be 2011 with a 3-year grace period for nonmembers until 2014, US investment advisers who currently market or expect to market to residents of the European Union should plan carefully around the proposed rule changes. Targeted to AIFM, the directive is a far-reaching piece of legislation that will significantly impact all advisers, regardless of whether

they are based in the European Union. Designed to allow regulators to monitor those advisers it believes pose a potential systemic risk to the economy, the directive will be targeted at advisers with assets under management in excess of €100 million where the manager uses leverage or €500 million where the manager doesn't use leverage and has a 5-year lock-up period.

The impact of this directive will be more far reaching than the proposed US legislation. This is because the directive includes portfolio and leverage disclosure requirements, capital requirements based on assets managed, independent valuation agent requirements, limitations on the use of non-EU depositories for the fund's assets, and, potentially, limitations on the amount of leverage that advisers will be able to utilize.

Perhaps more important to US managers will be limitations on their ability to market in the European Union. The proposed directive will require that non-EU advisers obtain an EU passport allowing them to market their funds in the European Union. Note that, while there is theoretical provision for non-EU domiciles with comparable regulatory oversight structures to obtain reciprocity arrangements with the European Union, history suggests that this will not be an easy provision to enact. For several decades, regulators have been unsuccessfully attempting to have reciprocal access for Undertakings for Collective Investment in Transferable Securities (UCITS) and US mutual funds with little progress, and it is therefore difficult to envision a scenario under which a reciprocal arrangement could be quickly reached between the United States and European Union for private funds. Based on how the rules are currently written, marketing in the European Union will likely require that US advisers establish a place of business in the European Union and become authorized to continue marketing to EU investors.

For the immediate future, investment advisers should continue to monitor the evolution of both proposals. While it is likely that both will go through some changes as the various regulatory agencies and constituents weigh in and propose amendments, we expect that fundamental changes are coming and that many in the industry must invest the time to understand and prepare for additional oversight and regulatory reporting.

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