

## Investors' Perspective on the European Commission Proposals on Regulation of Alternative Investment Fund Managers

### Introduction

There has been much discussion recently centered around the proposals of the European Commission for a Directive on Alternative Investment Fund Managers (the "Directive"). Much of the debate to date has focused on the potentially far-reaching impact of the Directive on alternative investment fund managers ("AIFM") and other service providers to the fund industry.

However, there is an increasingly audible voice from another quarter—that of the professional investor community.

While the Directive aims primarily to reduce systemic risk, another stated objective, and the focus of a large part of its provisions, is the protection of investors. The professional investor community stands to benefit from an increase in the level of investor protection under the Directive, but will also indirectly bear much of the associated compliance costs. The views of the investment community are therefore particularly relevant, both as a potential beneficiary of the advantages, and as an underwriter of the cost, of the Directive. Furthermore, the professional investor community (the sector to whom marketing of investments falling within the Directive is generally limited) is by definition skilled in assessing the merits of the investments it makes and therefore well placed to judge whether the costs the Directive would bring are warranted by the level of protection afforded.

The Directive has a number of potential advantages: it would, in many cases, raise regulatory standards for the AIFM industry and would, through the new passport, facilitate pan-European marketing of European alternative investment funds ("AIF"). It would ensure that AIF marketed in the EU benefit from independent

valuation and a depository network complying with European standards. It would also provide benefits for investors in terms of increased transparency and disclosure.

However, the Directive is not without disadvantages, which have been well documented in the legal press in relation to AIFM. The sections below contain a checklist of some of the implications of the Directive as they affect the professional investor community.

As we go to press, the Swedish government, as the President of the Council of the European Union, is consulting with other EU Member States on potentially far-reaching changes to the Directive. The proposals consider, amongst a range of options, the relaxation of the blanket limits on leverage, removing the notification requirements in relation to significant holdings and reducing the obstacles to marketing of non-EU AIFs. It is apparent from the nature of the alternatives tabled that the Presidency is taking feedback on the Directive seriously. We will continue to act for clients in this process and will report on developments. In the meantime, should readers wish to discuss any aspect of the Directive, any of the contacts listed at the end of this update would be happy to assist.

### Impact on Investors

#### Increased Costs

Increased costs for many AIF, and therefore their investors, will likely result from the following sources:

- Many AIF will be required to implement one-off structural changes as a result of the Directive, such as appointing an EU depository, manager and/or independent valuator (if they did not already have these

arrangements in place) and updating prospectuses.

- Ongoing compliance costs will arise for AIF directly or through their service providers in connection with various compliance requirements, such as AIFM/depositary costs associated with the Directive reporting requirements.
- Increased fees will arise for AIF investors if one-off and ongoing compliance costs of AIFM and other service providers are passed on to AIF, such as the need for AIFM to segregate management and risk functions, increased depositary costs due to the strict liability obligations imposed by the Directive and difficulties created by the restrictions on delegation outside the EU.
- The restrictions on delegation outside the EU will also restrict access to lower-cost delegate workforces.

### Impact on Performance/Strategy

The above costs will be a drag on performance to the extent passed on to investors. Constraints imposed by the Directive will also impact on AIF performance directly in the following ways:

- Leverage limits could constrain the ability of AIF that utilise significant leverage to increase returns.
- Disclosure requirements in connection with taking controlling influences may discourage activist strategies and make for more difficult and expensive private equity investments.
- Requirements in relation to short selling will also restrict AIF in utilising these investment techniques.
- Restrictions on appointing sub-depositaries in non-EU jurisdictions will impact on emerging market and other international funds accessing non-EU investments.
- Restrictions on delegating outside the EU would prevent the appointment of local managers in non-EU markets.
- The requirement for AIFM to obtain approval for changes in the AIF they manage would reduce agility in varying the investment objective and policy to changes in the market.
- Requirements in connection with liquidity management could negatively impact the amount invested (i.e., by increasing the amount of assets held in cash or cash equivalents) and the types of investments held.

### Reduction of Access/Choice

- The Directive compliance burden has the potential to squeeze out smaller start-ups and smaller existing players.
- The lack of access to the marketing passport for exempted AIFM (for example, those with assets under management of less than €100 million) will also restrict access to AIF of some smaller managers.
- Delays in availability of the marketing passport for non-EU AIFs until 2014 will significantly impact access to these funds.
- In addition, the onerous requirements for non-EU AIF recognition will act as a significant hurdle to marketing these funds in the EU even after 2014.
- The protectionist nature of the Directive provisions will raise the possibility of reciprocal action in other regions leading to polarization of marketing networks and restrictions on the efficient free flow of capital.
- Uncertainty over the final Directive will cause delay or cancellation of some new products coming into the market.
- The inability of some non-EU managers to actively market in the EU will further limit choice.
- The requirement for an EU depositary would exclude AIF with non-EU depositaries from distribution in the EU (or require change in depositary arrangements prior to this happening).
- Onerous requirements for depositaries in terms of liability and limitations on delegation have the potential to limit choices of good service providers for AIF and will likely lead to fee increases.
- Some non-EU managers may simply ignore the EU market in the future.

### Practical Difficulties in Holding Meetings with Managers

- Marketing restrictions for non-EU AIFM or for EU AIFM in respect of AIF falling outside the Directive may result in adverse change in the manner in which manager meetings, investor communications and investor relations are conducted.

### Disclosure/Confidentiality Issues

- The need to disclose the identity of holders of preferential terms would impact on the ability

to negotiate side letter terms and may restrict the range of classes/sub-funds within AIF.

may reduce the scope for investors to negotiate side letter terms.

**Tax Issues**

- The need for AIFM to exercise control over AIF as required by the Directive may adversely affect the tax residence of AIF.
- The limitations on marketability of non-EU AIF may affect the choice of structures available for efficient tax planning, treaty access, etc.

- Potential conflicts of interest arise in AIFM (not the AIF) being responsible for ensuring appointment of independent valuers and depositaries to AIF.

■ ■ ■

This update was authored by Peter D. Astleford (+44 20 7184 7860; peter.astleford@dechert.com) and Jim Baird (+44 20 7184 7469; jim.baird@dechert.com).

**Miscellaneous**

- The Directive requirement for AIFM to treat all investors fairly, while possibly advantageous,

**Practice group contacts**

For more information, please contact one of the lawyers listed, or the Dechert lawyer with whom you regularly work. Visit us at [www.dechert.com/financialservices](http://www.dechert.com/financialservices).

**Peter D. Astleford**  
London  
+44 20 7184 7860  
peter.astleford@dechert.com

**Gus Black**  
London  
+44 20 7184 7380  
gus.black@dechert.com

**Richard Frase**  
London  
+44 20 7184 7692  
richard.frase@dechert.com

**Jim Baird**  
London  
+44 20 7184 7469  
jim.baird@dechert.com

Dechert internationally is a combination of limited liability partnerships and other entities registered in different jurisdictions. Dechert has nearly 900 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Hong Kong, Luxembourg, Russia, the UK, and the US.

Dechert LLP is a limited liability partnership registered in England & Wales (Registered No. OC306029) and is regulated by the Solicitors Regulation Authority. The registered address is 160 Queen Victoria Street, London EC4V 4QQ, UK.

A list of names of the members of Dechert LLP (who are referred to as "partners") is available for inspection at the above address. The partners are solicitors or registered foreign lawyers. The use of the term "partners" should not be construed as indicating that the members of Dechert LLP are carrying on business in partnership for the purpose of the Partnership Act 1890.

Dechert (Paris) LLP is a limited liability partnership registered in England and Wales (Registered No. OC332363), governed by the Solicitors Regulation Authority, and registered with the French Bar pursuant to Directive 98/5/CE. A list of the names of the members of Dechert (Paris) LLP (who are solicitors or registered foreign lawyers) is available for inspection at our Paris office at 32 rue de Monceau, 75008 Paris, France, and at our registered office at 160 Queen Victoria Street, London, EC4V 4QQ, UK.

Dechert LLP is in association with Hwang & Co in Hong Kong.

This document is a basic summary of legal issues. It should not be relied upon as an authoritative statement of the law. You should obtain detailed legal advice before taking action. This publication, provided by Dechert LLP as a general informational service, may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome.

© 2009 Dechert LLP. Reproduction of items from this document is permitted provided you clearly acknowledge Dechert LLP as the source.

**EUROPE** Brussels • London • Luxembourg • Moscow • Munich • Paris • **U.S.** Austin  
Boston • Charlotte • Hartford • Newport Beach • New York • Philadelphia • Princeton  
San Francisco • Silicon Valley • Washington, D.C. • **ASIA** Beijing • Hong Kong