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A legal update from Dechert's Financial Services Group

European Commission Proposals on Regulation of Alternative Investment Fund Managers: The Effect on U.S. Managers and Their Funds

Introduction

The European Commission (the "Commission"), which is the executive branch of the European Union (the "EU"), has published its proposals for the regulation of the alternative investment fund industry, in the form of a draft Directive on Alternative Investment Fund Managers (the "Directive"). This follows a short period of intense speculation and discussion in this area in the wake of the global financial crisis and is one of the first attempts by international regulators to respond to that crisis.

The Directive sets out a supervisory framework for the regulation of managers of alternative investment funds ("AIFM") and the management and marketing of both EU and non-EU alternative investment funds ("AIF") within the EU. The definition of an AIF under the Directive would cover most, if not all, private funds (or, in the terminology of the proposals, "collective investment undertakings" both closed- and open-ended), that are not UCITS qualifying, therefore covering hedge funds, private equity funds, real estate funds, commodities funds, and non-UCITS retail funds.[1]

This *DechertOnPoint*:

- provides a brief summary of some of the key provisions of the Directive;[2]
- considers more in depth the provisions of the Directive that may impact United States AIFM and the AIF they manage; and
- discusses the Directive in the context of other steps that are being taken by the United States government to regulate the alternative investment sector.

Summary of the Key Provisions of the Directive

- An AIFM that wishes to provide management services to, or market the units of, an EU AIF must be authorized in a member state of the EU (a "Member State"), subject to certain de minimis exemptions.
- AIFM that have been authorized in a Member State will be able to apply to their home Member State regulator to passport the AIF they manage to be marketed to professional investors[3] in any other Member State following a notification procedure; however, this passport will not be available in respect of non-EU AIF for three years from the date of adoption.

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[1] UCITS are regulated funds organized in European jurisdictions that have adopted the UCITS Directive and that are offered to retail investors.

[2] For a more detailed discussion of the Directive please refer to *DechertOnPoint*, Issue 9 (August 2009) available at: www.dechert.com/library/FS_9_0809_European_Commission_Proposals.pdf.

[3] "Professional Investors" for these purposes is as defined in the Market in Financial Instruments Directive ("MiFID"). However, the MiFID definition is actually of a "professional client" rather than a "professional investor," but the intention of the Commission is clearly to identify investors who possess the experience, knowledge, and expertise to make their own investment decisions and properly assess the risks that their investment entails.

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- AIFM will have to comply with certain ongoing operating requirements relating to (1) conduct of business (including conflicts of interest, risk management, and liquidity management); (2) ongoing minimum capital; (3) organization of the AIF they manage (including appointment of an independent valuator and custodian where relevant (that must be a European bank or other credit institution)); and (4) delegation.

- Authorized AIFM must appoint EU credit institutions as depositary/custodians for the AIF they manage.

- Valuation of the assets acquired by, and the value of the shares and units in, AIF managed by authorized AIFM must be carried out independently of the AIFM. An AIFM must ensure that the valuator has appropriate and consistent procedures in place to value the assets of the AIF.

- AIFM must provide disclosure on a regular basis to both investors and competent authorities, including information relating to markets, instruments, principal exposures, and important concentrations. AIFM must also report to regulators the liquidity arrangements and AIF risk profiles and risk management tools that AIFM use.

- An AIFM that acquires a controlling influence in a company must disclose information to shareholders and representatives of employees of the portfolio company in which it acquired a controlling interest.

- AIFM established outside the EU ("non-EU AIFM") are not covered by the Directive unless they affirmatively seek to become authorized in accordance with the Directive. Under Article 4 of the Directive, non-EU AIFM that have not been authorized in accordance with the Directive are not permitted to:

  - Provide management services (i.e., the activities of managing and administering) to an AIF domiciled in the EU (and the Directive provides no mechanism for non-EU AIFM to become authorized for these purposes).

  - Provide portfolio management or risk management services, even pursuant to a delegation agreement from an authorized AIFM (and the Directive provides no mechanism for non-EU AIFM to become authorized for these purposes).

  - Market units or shares of an AIF (whether or not domiciled in the EU) within the EU, other than under the applicable private placement regimes in each Member State. That is to say, a private fund that is not organized or domiciled in the EU (e.g., a U.S. fund or a Cayman fund) could not be sold to European investors for a three-year period following the implementation of the Directive. Following such three-year period, a non-EU AIFM will be able to seek authorization from a Member State to market AIF within the EU.

The Impact of the Directive on U.S. Managers and their AIF clients

Authorization of AIFM Established Outside of the EU

The substantive provisions of the Directive do not extend the marketing passport under the Directive to non-EU established AIFM. However, Member States are permitted, from a date commencing three years after the coming into force of the Directive, to authorize non-EU AIFM to market units under the Directive to professional investors in the Member State subject to certain strict pre-conditions:

(i) The AIFM's country of domicile is approved by the Commission as having prudential regulation and ongoing supervision equivalent to the Directive;

(ii) the third country domicile is approved by the Commission as granting EU AIFM effective market access comparable to that granted by the EU to AIFM from that third country;

(iii) the AIFM provides to the relevant Member State equivalent information as would be required for an authorization and marketing passport application by an EU-based AIFM;

(iv) a cooperation agreement exists between the competent authority of the member state and the supervisor of the AIFM that ensures an efficient exchange of information relevant for monitoring the activities of the AIFM to ensure the stability and the orderly functioning of markets; and

(v) the third country has signed an agreement with the Member State that fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information on tax matters.

For registered U.S. investment advisers, it will likely be difficult to comply with the requirements above, as such advisers are not currently subject to any prudential regulation by their home regulator and there are currently no plans to change this.

Following the period of three years from the implementation of the Directive, permission to market AIF by a non-EU AIFM may be applied for on a Member State-by-Member State basis. It is unclear how easy in practice this provision will be to invoke.

Indeed, in circumstances where the non-EU AIFM are managing non-EU domiciled AIF, the provision may be of little practical assistance if the AIF themselves are not permitted to be marketed under the Directive for a period of three years after the implementation of the Directive.

The Explanatory Memorandum accompanying the proposed Directive does state that during this three-year period, Member States may allow or continue to allow non-EU AIFM to market AIF domiciled outside the EU under existing private placement rules in each of the Member States. However, the ability to market in Member States subject to national law will, in some countries, be subject to far greater restrictions than would be the case under the Directive. Consequently, for the first three years following adoption, non-EU AIFM and non-EU AIF (whether managed by an EU AIFM or a non-EU AIFM will be at a disadvantage to EU funds (or potentially barred from being offered) in certain EU jurisdictions.

Marketing of Non-EU AIF

Regardless of whether or not they are marketed by an EU authorized AIFM, non-EU domiciled AIF will not be allowed to take advantage of the marketing passport provisions of the Directive for a period of three years from the implementation of the Directive. During this time, they will only be able to be marketed within the EU under the private placement laws that exist in the varying Member States and that differ from Member State to Member State. This clearly introduces a less than level playing field for investment management groups managing non-EU based funds.

After the three-year period, AIF domiciled outside of the EU will only be eligible for a passport if they meet certain requirements, including (under the current draft of the Directive) a requirement that the jurisdiction in which the AIF is domiciled has entered into an agreement with the relevant Member State where investors are located which complies with the OECD Model Tax Convention relating to the exchange of tax information. This is a matter that many offshore jurisdictions are currently working towards but do not yet have in place with most EU Member States.

Delegation by AIFM Entities

As indicated above, the Directive prevents the delegation of AIFM activities involving portfolio management or risk management outside of the EU.

The Directive provides that delegatees in respect of these services must be authorized as an AIFM to manage an AIF of the same type. This is particularly troublesome for large asset management groups that would not be able to delegate investment management activities to their offices outside of the EU. Also important to note is that if a non-EU AIFM delegates responsibilities for an AIF to an EU AIF, then the EU AIF will be under an obligation to ensure that the relevant AIF meets the requirements under the Directive.

In addition, from a date commencing three years after the coming into force of the Directive, AIFM may only delegate administrative services to entities established in a third country if:

(i) The general requirements as to delegations by AIFM under the Directive are met (i.e., prior authorization on a case-by-case basis);

(ii) the entity is authorized to provide the administration services or is registered in the third country and is subject to prudential supervision; and

(iii) there is an appropriate cooperation agreement in place between the third country and the home state regulator of the AIFM.

Any such administrator will not be allowed to be the same entity as the valuator.

The definition of "management services" is very wide-ranging and appears intended to cover more than pure investment management functions. It is, therefore, unclear whether this provision is intended to attach to the outsourcing of middle office administration of the AIFM's investment management function or the outsourcing of administration services relating to the AIF itself.

Non-EU Domiciled Valuators

The Directive requires an AIFM to ensure that for each AIF it manages, a valuator independent of the AIFM is appointed to value the assets of an AIF and its shares or units. The AIFM must also ensure the valuator has appropriate and consistent procedures in place to value the assets of an AIF.

The Directive also imposes restrictions on the appointment of a valuator outside of the EU. The Directive provides in this respect that, from a date commencing three years after the coming into force of the Directive, Member States may only allow the appointment of a valuator established in a non-EU country provided that the country is approved by the Commission as having valuation standards and rules used by valuators in the territory that are equivalent to those applicable in the EU. The Commission is required to adopt implementing measures specifying the criteria for assessing the equivalence in this regard.

It is not altogether clear how the Commission proposes to enforce this requirement, which as drafted would appear to extend the jurisdiction of the Directive to AIF established outside of the EU. However, following the three-year transitional period, it clearly prevents AIFM from providing management services to non-compliant AIF and would appear to restrict the ability of AIFM in the EU to provide management services to AIF that may use non-EU based administrators.

Conceivably, this would also present a difficulty for a number of administrators in jurisdictions such as Ireland, for example, which use non-EU based group companies to provide services in respect of their clients.

Non-EU Based Depositary Services

Under the Directive, an authorized AIFM is required to ensure that a depositary (custodian) is appointed to fulfill various safekeeping responsibilities in relation to the AIF the AIFM manages.

The AIFM is also required to ensure that the depositary is an authorized credit institution having its registered office in the EU. This, taken together with the restrictions on delegation to other depositaries, restricts the appointment of non-EU based sub-custodians.

Clearly, this is totally unworkable for an international investment fund investing in non-EU markets. Perhaps in recognition of this, the Directive provides in Article 38 for the appointment of sub-depositaries domiciled outside of the EU. However, this provision is flawed in a number of respects:

- The permission only comes into force from a date commencing three years after the coming into force of the Directive;
- the provisions only apply in relation to non-EU domiciled AIF, which is clearly not helpful at all to EU domiciled AIF;
- the permission only extends to sub-depositaries appointed in the same jurisdiction as the non-EU domiciled AIF, which does not address at all the requirements of an international investment fund with sub-custodians in non-EU jurisdictions in which the AIF invests; and
- the delegation may only be effected if:

(i) the third country is approved by the Commission as having affective prudential regulation and supervision equivalent to the provisions laid down in EU law;

(ii) cooperation between the home Member State and the relevant authorities of the third country is sufficiently ensured; and

(iii) the third country is subject to decision by the Commission that the standards to prevent money laundering and terrorist financing are equivalent to those laid down in EU law.

Clearly, an emerging market fund (and indeed funds investing in certain developed markets) may have difficulty satisfying these criteria. Indeed, the requirement that the depositary's liability towards investors is not affected by reason of the delegation to a third country depositary of all or part of its tasks, is unlikely to encourage depositaries to agree to provide services to AIF that invest in these markets.

Similar Steps in the United States?

In the current financial climate, many countries are looking to further regulate their investment management industries. In the United States, several steps have already been taken, in the form of the legislative pro-

posals and proposed amendments to existing legislation, such as:[4]

(i) the Hedge Fund Transparency Act of 2009, which would effectively eliminate the 3(c)(1) and 3(c)(7) exceptions from registration under the Investment Company Act of 1940, as amended (the "Investment Company Act"), and replace them with a new registration regime that would exempt such funds from most of the substantive provisions of the Investment Company Act pursuant to a new Section 6(a) of the Investment Company Act;

(ii) the Hedge Fund Adviser Registration Act of 2009, the Private Fund Transparency Act of 2009 (the "Private Fund Transparency Act"), and the Private Fund Investment Advisers Registration Act of 2009 (the "Private Fund Advisers Registration Act"), each of which would repeal the Section 203(b)(3) "Private Adviser Exemption" under the Investment Advisers Act of 1940, as amended. The Private Fund Transparency Act and the Private Fund Advisers Registration Act would each create a foreign private adviser exemption and provide for new recordkeeping and reporting requirements to enable the Federal Reserve to better manage "systemic risk," which would include producing records of 3(c)(1) and 3(c)(7) investment companies managed by a registered adviser; and

(iii) the Consumer Financial Protection Agency Act of 2009, which would lead to the creation of a new federal agency to regulate the provision of consumer financial products or services.

The effect of all of these initiatives (if enacted into law) would be a much greater degree of supervision of the management of investment companies with U.S. clients, regardless of the domicile of the investment manager.

To date, however, it does not seem that the U.S. proposals have been as overtly protectionist as those put forward in the Directive and, as yet, there has been no official response to the Directive by the U.S. government or regulatory bodies such as the SEC and FINRA. However, some form of more protectionist legislation could be on the horizon (despite the claims of the leaders of the G20 to the contrary), and the United States, like the EU, is looking to "regulate" offshore market participants. Congressional proposals would also impose a U.S. investment adviser registration obligation on foreign advisers that have any U.S. clients (if the assets under management attributable to U.S. clients exceed $25 million).

Recent comments made by SEC Chairwoman Schapiro have led many to believe that the SEC will be cracking down on non-U.S. market participants operating within the United States, and the SEC announced at the start of 2009 that it would be taking action against two non-U.S. firms for failing to register in the United States as broker-dealers.

However, the Directive does seem to go further in its "protectionist" approach to regulation. While the U.S. bills set out above, and the approach of the SEC, would seem to be designed to protect the stability of the U.S. financial markets, the Directive seems also to be attempting to limit participation in the EU market by non-EU domiciled entities, including funds, managers, and depositories.

It is far from clear that U.S. advisers and offshore funds would be able to meet the requirements set out in the Directive to enable them to obtain authorization and/or market effectively within the EU, and proposed restrictions in the Directive on the use of leverage and investments in securitizations[5] go beyond anything currently envisaged in the United States.

It will be interesting to see how the United States responds to the Directive. Will it be equally protectionist, or will it view this as an opportunity to assert a competitive advantage over a soon-to-be highly regulated EU marketplace?

We will be following carefully any developments on that front, as well as any U.S. response to the Directive.

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4 For more information on these legislative proposals and related topics, please refer to our regular *DechertOnPoints* available here.

5 For more details, please refer to *DechertOnPoint*, Issue 9 (August 2009) available at www.dechert.com/library/FS_9_0809_European_Commission_Proposals.pdf.

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