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More Time than Sense: Hedge Funds and the Making of the AIFM Directive

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Ignorance...Is Not Bliss

In the wake of the most recent shenanigans in Europe over the regulation of Alternative Investment Fund Managers (AIFM), one cannot help but think that a number of the European lawmakers behind the still yet to be settled text of the AIFM Directive, would benefit by reading the recently published "More Money Than God: Hedge Funds and the Making of a New Elite", which addresses the ignorance with the hedge fund industry clearly prevalent across the globe...and seemingly in the EU.

"Politics: A Strife of Interests Masquerading as a Contest of Principles"

Not since the height of the debate on the EU Takeovers Directive has a piece of EU legislation been so hotly debated, reaching dizzying political heights and attracting the attention of a wide range of interested parties, from hedge funds to union representatives!¹ An unprecedented 1,700 suggested amendments to the original European Commission text were received by the influential Jean-Paul Gauzes,² who having sat through 137 conversations with lobbyists, had hoped he would be 'the man' who would do the miraculous and bring the Member States to a consensus, after the failures of the Swedish³ and Spanish⁴ compromises.

The reason for the divergence of interests among Member States is not that dissimilar from the issues that hampered the implementation of the Takeovers Directive for years: the desire to introduce a harmonized system of rules without an agreed view among Member States about what the "issues" raised and needed to be addressed, and

without a level playing field. Once again, as in the case of the Takeovers Directive, (where the UK's starting point was that it already had in place a sophisticated set of takeover rules and regulations, some paternalistic in nature, which had served the open vibrant public M&A market well), in the case of the AIFM Directive, the UK's starting point was that its existing system of regulation of hedge funds through a combination of Financial Services Authority (FSA) rules and good corporate governance standards tailored for the industry (both hedge funds and private equity funds), were sufficient and that attempts at introducing a harmonized set of rules would inevitably disproportionately affect the UK (home to about 80% of Europe's hedge fund industry).

So Close, But Not Close Enough ... The Belgian Compromise?

The proposed AIFM Directive is subject to the ordinary legislative procedure at the EU level. This means that in order to become law, the Directive must be adopted by both the European Parliament and the European Council. Accordingly, the Commission's original proposals are considered, amended and voted on (in parallel) by Member State governments in the European Council and the by the European Parliament. On May 17, 2010, the European Parliament adopted their positions on the proposed directive and the following day the Council adopted its position - the two different with the former being slightly "friendlier" to the UK's position. The hope had been that the Council and Parliament would negotiate to adopt a common position with a view to it being adopted by the Plenary session of the European Parliament on July 6. Following a series of meetings between parliamentarians, EU states and the Commission, it became clear that an agreed position would not be reached this side of the summer and accordingly, there was a formal postponement of the vote of the new rules. The haggling will continue over the summer under the auspices of the new presidency of Belgium. The hope is that an agreement will be reached in time for a September vote.

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Risks?! ... What Risks?

While the Explanatory Memorandum (EM) to the draft Directive refers to the risks, exposed in the wake of the financial crisis, to which AIFMs are vulnerable and the need to address them, the proposals go beyond addressing the issues of the financial crisis and has, in a number of areas, been used as a tool to progress by some Member States "ignorant of the economic utility of hedge funds, short selling and active shareholder governance, who have pushed for provisions in the proposed Directive to hamper these legitimate activities."

Why should AIFs be subject to stricter short selling rules, when short selling (in particular, naked short selling) is used by a range of different market participants? The market competitive disadvantage, which the proposals bring in this regard, gives rise to concern. The draft proposals also require enhanced transparency in relation to investment policies and strategies thereby affecting hedge funds, but also through the proposed rules requiring enhanced disclosure by controlling shareholder AIFs (whether in listed or non-listed securities) of business plans etc., not just to shareholders but even to employee representatives. What have these proposals to do with eliminating the macro and micro systemic risks associated with AIFs and their role in the financial crisis?

The EM recognizes that AIFMs come in all shapes and sizes, varying considerably in terms of investment techniques, asset markets and target investor populations. Yet, the broadly drawn draft proposals inevitably provide for a "one size fits all" approach in many key areas. As currently drawn, the proposals will impact hedge funds, private equity funds, real estate investment funds, venture capital trusts and investment trusts. The Directive may even cover certain vehicles or structures such as corporate enterprises that are not typically regarded as "investment funds" - there are still no answers to this and many other questions.

Key Road Blocks

The provisions which have drawn most public attention and which have been heavily debated relate to the so-called "third country" issue: the ability of EU authorized managers to market non-EU domiciled funds and the ability of non-EU domiciled managers to market funds into the EU. Article 35 imposes restrictions on the marketing of AIF which are domiciled outside the EU. In particular, it is necessary for such funds to be located in jurisdictions which made agreements in line with the Organization for Economic Cooperation and Development (OECD) tax convention with Member States and where requirements on depositaries (see below) are equivalent to those under the AIFM Directive. In relation to allowing AIFMs established in a non-EU country to market into a EU Member State, a Member State can only authorize such a third party if four conditions are met, including that they come from a jurisdiction with equivalent rules to the EU. Given that 94% of global assets under management (AUM) in hedge funds is domiciled outside the EU, there is a serious concern in the hedge fund sector regarding the

loss of access to a variety of funds.

The other key road block that has attracted much attention are the proposals around disclosures required by portfolio companies with an AIF as a 10% /> shareholder. This would have a direct impact on private equity backed portfolio companies, and in a market where private equity acquisitions are already difficult to get away, this proposed legislation could have a significant sinking effect.

Is There a Need For Any Change?

While it is not being suggested that there was no place for the introduction of regulation in respect to certain funds to assist with flushing out and/or mitigating some of the systemic risk issues identified, what is being objected to is bad regulation.

Take the issue of disclosure, for example. There clearly has been a need for increased transparency and disclosure in SOME operational and related areas impacting AIFs. The proposed rules, however, do not (currently) provide clarity on a tailored approach for different types of funds (as highlighted above) and more importantly, the proposed disclosure rules go beyond areas of operation significance.

Is It All Bad?

Neither is it being suggested that the entirety of the AIFM Directive draft proposals have no merit whatsoever. In particular, the ability for an AIFM (once authorized in one Member State) to be able to passport into all other EU Member States certainly will bring access to funds not previously marketed in certain Member States. As the Charles River Associates Report[®] (the "CRA Report") points out, "This would enable efficiencies to be exploited, thus lowering costs."

The other area of potential benefit is in relation to the requirement for an AIFM to have in place for each AIF it manages, an independent valuator to establish (at least once annually) the value of assets acquired by the AIF and the value of the shares and units of the AIF. In the light of the significant variations in private equity valuations revealed in the media[®] that potentially have left investors in these AIFs obfuscated, these valuator requirements similarly do have some merit.

Everything Comes With a Cost...And This One Is Colossal

One of the possible impacts of the AIFM Directive is the flight to Undertakings for Collective Investments in Transferable Securities (UCITS), as hedge fund managers look to escape the heavy-handed regulatory approach taken in the AIFM Directive. Apparently, 80% of live funds in each hedge fund strategy already meet the risk requirements for UCITS (as measured by value at risk or "VAR"). Is this necessarily a bad thing -that is, hedge funds offering their strategies via regulated UCITS funds? Well, as UCITS are generally thought of as lower risk than hedge funds, this may benefit investors.

While the market may continue to speculate over the flight to UCITS, one area which is very clear in terms of

market impact is the heavy, heavy cost of compliance. The CRA Report measures the one-off compliance costs as reaching up to €3.2billion, arising due to rules on delegation and changes to legal structures which may require restructuring of business models, and of course re-domiciling funds outside the EU into the EU. The CRA Report also estimates ongoing compliance costs of around €311million. These costs, of course, will pass on to investors. One of the new areas of key change are the rules relating to the strict liability of depositaries to the AIFM and investors of the AIF for any losses suffered by them as a result of the depositaries failure to perform its obligations under the AIFM Directive. Depositaries never having faced this liability are expected to seek insurance cover for the same and through enhanced compliance and monitoring operational changes will inevitably increase their fees and thereby investors will end up bearing these costs.

While perhaps overly emotive, Andrew Baker's¹⁰ statement about the impact of the AIFM Directive stresses the wider negative impact:

"Of course hedge funds and private equity industries would be impacted by a flawed Directive, but the consequences would be much wider...Real estate and infrastructure investment in Europe would also be impacted because funds in this sector would also be covered by the Directive. We're talking about schools, hospitals, shopping centers, things that affect ordinary EU citizens...."

1. Sebastian Mallaby, Penguin Press
2. See UNITE the Union press release - http://www.unitetheunion.com/resources/political_department/unite_in_europe/eu_news/finance_aifm_directive__less.aspx
3. French MEP who is responsible for steering the legislation through the European Parliament
4. On 12 November 2009, the Swedish Council Presidency published a compromise proposal for an AIFM Directive and

revised this twice on 25 November and 15 December. Alas, on 2 February 2010, the Financial Markets Law Committee published a paper highlighting inter alia provisions of the Swedish compromise and said that unless the provisions are amended, they could lead to "systemic failure and widespread market disruption".

5. On 4 February 2010, the Spanish Council Presidency published a new compromise proposal revising this a number of times subsequently. The UK based, Alternative Investment Management Association (AIMA) publicly warned on 16 February that this compromise reinstated a provision from the original European Commission text which may result in EU investors being prevented from accessing non-EU funds and managers. Not surprisingly, even after further revisions, in the COREPER report of 12 May 2010, it was noted that the UK and Czech delegations had entered reservations about the text

6. Which in simple terms applies to all alternative investment funds (AIFs), other than those which are subject to authorisation requirements of the UCITS Directive or whose AUM is less than €100m (in the case of leveraged AIFs) or €500m (in the case of non-leveraged funds without early (i.e. not within first 5 years) redemption rights)

7. At this stage, there is no indication of which jurisdictions would be able to satisfy the four conditions. In particular, there is no clarity as to where the US domiciled AIFMs and AIFs would stand.

8. In 2009, the UK Financial Services Authority commissioned an impact assessment by Charles Rivers Associates on the AIFM Directive (published on 15 October 2009)

9. Financial Times, 28 June 2010 - Blackstone and TPG are revealed as providing their investors with "dramatically different valuations for one of their biggest common holdings"

10. CEO of AIMA - statement made on 14 May 2010m just ahead of the two votes on the Directive by the European Parliament and Council, on 17 and 18 May 2010 respectively

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