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The AIFM Directive: Implications For Non-EU Managers

Law360, New York (August 25, 2010) -- In May 2010 the European Parliament and the Council of the European Union each approved its own version of a draft Directive on Alternative Investment Fund Managers.

The directive remains a work in progress and the subject of intense lobbying efforts and political wrangling. Once a final version is implemented, the directive will introduce a harmonized regulatory and supervisory framework across the European Union for alternative investment fund managers and will significantly affect the operation and marketing of alternative investment funds, including hedge funds and private equity funds.

The considerable differences between the Parliament's and the Council's drafts will not be resolved until a compromise version is negotiated and agreed, which is not expected to occur until at least September 2010.

Among the key unresolved issues are provisions relating to treatment of non-EU managers that market non-EU funds to EU investors, including provisions relating to disclosure requirements, limitations on leverage and on employee compensation and other operational matters.

Although significant uncertainty remains about the application of the directive to non-EU managers, managers outside the EU should be aware of the potential implications of the directive for their businesses and should be preparing for operational adjustments that will be necessary to address the new regulatory landscape.

The "Third Country" Rules

The two versions of the directive adopted by the Parliament and the Council reflect fundamentally different approaches to "third country" matters (i.e., the application of the directive to non-EU managers).

For example, the Parliament's version would permit funds domiciled outside the EU to benefit from a marketing "passport" if the fund's home country meets certain criteria and the other conditions of the directive are satisfied. By contrast, the Council's text would maintain the approach of the current system, under which non-EU funds must be marketed within the EU under the separate, national private placement regimes.

In addition, the impact of the directive on the operation of funds organized outside the EU (e.g., in the United States and the Cayman Islands) that market to EU investors will depend on the ability of non-EU regulators to comply with relevant requirements of the directive.

Depending on the language included in the final version, the directive may permit marketing of non-EU funds in the EU only if the non-EU regulator or country (i) enters into a cooperation agreement with the EU countries in which the funds are marketed; (ii) complies with rules regarding market access, sharing of tax information, anti-money laundering and similar matters; and/or (iii) enforces the directive and acts as an agent for EU regulators.

The ability or willingness of non-EU regulators to comply with EU requirements is at best uncertain. The Cayman Islands, which is the domicile for thousands of funds, is likely to make every effort to comply, because of the importance of the funds industry to the islands' economy.

However, it may be unrealistic to expect the U.S. Securities and Exchange Commission, the Hong Kong Securities and Futures Commission, and other non-EU regulators to act as agents for EU regulators to enforce the directive on locally registered fund managers.

In addition, the rules may even prevent a non-EU fund manager that is not registered with a home country regulator from complying with the directive and, therefore, from being able to market its funds in the EU.

Based on the Parliament's and the Council's drafts, other potential implications of the directive on non-EU managers that market non-EU funds to EU investors are likely to include the following:

First, a non-EU manager of a Cayman or other non-EU fund that is marketed to EU investors will need to comply with a number of disclosure and reporting requirements. Specifically, the directive will require the manager to:

--Distribute audited annual reports (containing financial statements and a report on the fund's activities) to regulators and to investors on request;

--Disclose certain information regarding the fund (e.g., a description of the investment strategy and all associated risks and other information generally of the type found in private placement memoranda) to investors prior to the date of investment and periodically thereafter; and

--Provide regular reports to the home country regulator that include, among other information, aggregated data on the main instruments in which the manager trades, markets on which it actively trades and the principal exposures of each of the funds it manages.

Second, under the Parliament's approach, a non-EU manager of a Cayman or other non-EU fund that is marketed to EU investors would also be subject to additional substantive regulation in the following areas:

Leverage. The manager would be required to disclose to its applicable regulator (e.g., the Cayman Islands Monetary Authority in the Cayman Islands) information about the overall level of the fund's leverage, a breakdown between leverage arising from borrowing of cash or securities, the five largest sources of borrowed cash or securities and the amounts of leverage received from each of those sources.

The regulator would also need to ensure that each manager sets appropriate leverage limits for each fund.

Restrictions on Asset Stripping. The capital adequacy regime under the Second Company Law Directive, which is a set of existing rules that currently applies to public companies, would apply to a target company "controlled" by a fund.

This would restrict such a company from giving financial assistance for the purchase of its own shares, including the pledge of a portfolio company's assets as security for debt, and could make leveraged buyouts more difficult or costly to finance or, in tight credit markets, impossible to finance.

The intended territorial scope of this provision is unclear, although the likely focus of the restriction is target companies incorporated in the EU that are controlled by a fund (wherever organized) managed by a manager (wherever organized). We would expect this ambiguity to be clarified in the final text or implementing regulations if this provision is adopted.

Portfolio Company Disclosure. If a non-EU manager covered by the directive acquires “controlling influence” over a listed or unlisted company in the EU, the manager would be required to disclose the following to its home country regulator and the relevant governmental authority of the member state where the company is established, as well as to the company, its shareholders and its employees or employee representatives: (i) information regarding planned significant divestments of assets; (ii) the policy for preventing and managing conflicts of interest, in particular between the manager and the portfolio company; (iii) the policy for external and internal communications, particularly with respect to employees; (iv) the person or person authorized to conclude legally binding agreements relating to business strategy and employment policy; and (v) other matters relating to the manager.

Remuneration. Prescriptive remuneration policies would apply to the employees of the manager of funds marketed to EU investors whose professional activities have a material impact on the risk profiles of the funds they manage (e.g., senior management and other risk takers). These policies would apply both to the remuneration paid by the manager and to the remuneration paid by the funds themselves, including carried interest.

However, the practical application of these policies to carried interest, performance fees or other compensation paid by a private equity or hedge fund to its manager is not yet clear.

Other Areas of Regulation. Additional rules relating to conflicts of interest and supervision by regulators would apply. In addition, a non-EU hedge fund manager (but not a private equity fund manager) would need to comply with other rules in relation to periodic valuations and to depositary, risk management, liquidity management and capital requirements.

Third, the directive distinguishes between marketing to “professional investors” and “retail investors.”

Professional investors include institutional and individual investors who have the experience, knowledge and expertise to make their own investment decisions and properly assess the risks that they incur and comply with certain other criteria.[1] Any investor that is not a professional investor is a retail investor.

Under the directive, each EU member state may allow a manager to market funds to retail investors in its territory regardless of where the manager is established, but the member state may impose requirements on marketing to retail investors that are more stringent than the requirements applicable to professional investors in its territory.

Therefore, a non-EU manager may need to comply with additional requirements in order to market to retail investors in the EU.

In addition, the Parliament’s version contains a provision that explicitly prohibits the marketing of a fund of funds to retail investors in the EU if the fund or funds invests more than 30 percent in funds that do not benefit from the EU marketing passport (in other words, funds with managers that are not authorized under, or that do not otherwise comply with, the directive).

Key Considerations and Strategic Alternatives

As the process of finalizing the directive runs its course, a non-EU manager hoping to raise capital in the EU should begin planning for the long-term impact of the new rules on its structure and business. Some key considerations are as follows:

Cost. In many cases, non-EU managers seeking investors in the EU under the directive will face significant new compliance costs. These costs will include one-time restructuring expenses associated with the adjustments necessary to establish the relevant systems and arrangements to comply with the directive.

One study estimates that the directive will impose substantial one-time compliance costs of up to €3.2 billion in the aggregate on managers.[2]

In addition, managers and funds will incur significant ongoing compliance costs, including investor disclosures and valuation costs. These costs will likely be passed on to investors, leading to reduced returns.

Establishing Funds in the EU. Some non-EU fund managers are already evaluating whether to establish funds in the EU in order to avoid the uncertainty and potential complexity of complying with the directive with respect to their non-EU funds.

For example, some non-EU hedge fund managers are considering establishing EU-based investment vehicles such as Undertakings for Collective Investments in Transferable Securities.

Although UCITS are regulated and subject to significant regulatory restrictions, management of UCITS will not trigger application of the directive.

UCITS have the further advantage of being familiar to both regulators and investors. Ireland and Luxembourg have well-established UCITS structures and offer some of the advantages currently provided by the Cayman Islands and other currently favored offshore jurisdictions, such as low or no taxes on funds and a developed fund administration infrastructure.

However, UCITS are largely retail funds — the sole object of a UCITS must be to invest capital collected from the public in transferable securities based on the principle of risk spreading.

Therefore, the option of restructuring a fund as a UCITS may not be available to funds established for institutional investors that have a different investment focus.

Further, some aspects of a UCITS vehicle may not be attractive to the managers of non-retail funds (e.g., the restrictions on the investment policies of a UCITS fund, specific obligations regarding the depositary and UCITS management companies, and more restrictive requirements on liquidity, concentration and counterparty exposure limits).

Discontinue Marketing to EU Investors. Non-EU managers (especially those for whom raising capital from EU investors is less important strategically) may consider whether to abandon marketing efforts in the EU as a result of the cost and heightened regulatory burden that would result from marketing funds in the EU.

Possible Competitive Distortions. As a result of current lobbying efforts, it is possible that the final version of the directive will exempt non-EU funds or non-EU managers from provisions that apply to EU funds and managers.

The consequence could be to give non-EU funds a competitive advantage in raising or investing capital in the EU. In a worst case, it could result in a flight of funds or managers from the EU.

In the coming months, the funds industry and industry advisers will need to keep a watchful eye on developments in order to be prepared to address the implications of the directive when it emerges in its final form.

--By C. William Thomas Jr. (pictured) and Jay Ze, Gibson Dunn & Crutcher LLP

William Thomas is a partner in the corporate transactions department of Gibson Dunn & Crutcher's Washington office. Jay Ze is an associate with the firm in the London office.

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[1] A high net worth individual (and his or her family office) will automatically qualify as a "professional investor" for this purpose only if it satisfies two of the following criteria: (i) he or she has carried out transactions, of significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters; (ii) the size of his or her financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds €500,000; and (iii) he or she works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

[2] "Impact of the Proposed Manager Directive across Europe," a paper to the Financial Services Authority by Charles River Associates dated October 2009, at page 112.