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Financial Services and Markets

Fundamental change for the fund industry

The European Commission has proposed a directive on Alternative Investment Fund Managers, the stated aim of which is "to provide a clear and consistent framework for the regulation and supervision of managers of alternative investment funds in the EU". Once the European consultation and legislative procedures have been completed, the Directive will result in new European law which will need to be implemented in each EU jurisdiction by a combination of law and regulatory rules. In this paper we expand on the initial summary in our note of 30 April 2009.

Introduction

While the main focus of the directive is on the person who provides "management services" to the fund, the fund vehicle itself will become subject to indirect regulation through its manager; this is so irrespective of where the fund is domiciled.

In its current form the Directive will have significant and unwelcome implications for the EU alternative investment fund management industry and for those who provide services to it. This includes all vehicles for collective investment which are not regulated UCITS funds: private equity, real property, debt, commodity, infrastructure, film and hedge funds, long-only funds, VCTs, investment trusts and REITs, and even domestically regulated funds such as UK QIS and NURS. However, if the proposal is modified so that its worst elements are removed, it has the potential to improve the environment for unregulated funds as it should reduce significantly the cost and legal uncertainty of cross-border marketing, but this nirvana is some way away.

Timing

The Commission has stated its intention for the Directive to be finalised by the end of this year. However, in view of the contentious nature of the proposals and the intensive lobbying and consultation which will follow the publication of the proposal, 2010 is perhaps more realistic. EU States will then have a further period in which to amend their laws and regulatory rules.

There will be a transitional period, giving EU managers of EU domiciled funds one year to comply after the Directive comes into force. Where funds are outside the EU, the non-EU jurisdictions have three years to meet specified EU standards if they wish to market their funds within the EU. EU standards must also be met by some overseas service providers after three years.

Why?

The proposal is a response to a range of different issues, some of which have been around for some time, but which have been given impetus by the recent financial turmoil and associated scandals. There are also political influences at work and, since the largest part of the alternative fund industry is London based, there are concerns that this is an attack on the City. It would, however, be a mistake to think this is only about hedge funds and private equity and is driven by just a few politicians.

In this context key drivers for change include:

- the enormous political pressure placed on the Commission in relation to the activities of some hedge and private equity funds, in particular, in relation to short selling and leveraged investment in EU companies. The Rasmussen and Lehne reports which were adopted by the European Parliament last year were highly critical of the hedge fund and private equity industries.
- the impact of the Madoff affair, which should not be underestimated. Some EU countries have always been hostile to the marketing of non-EU funds, over which they feel they have no control, and the Madoff affair has given weight to their views. The fact that EU investors (including professional investors) were exposed to Madoff through funds based and/or marketed in the EU has clearly influenced the Commission, particularly in relation to investor protection issues such as marketing, custody and valuation of investments.
- the "credit crunch". Some funds were heavy sellers of investments in order to meet redemption requirements, which is thought to have had market impacts. Others had to suspend redemptions, affecting investors. Some hedge funds have suffered significant losses as a result of using investment techniques under which fund assets were transferred to Lehman in return for leverage.
- the current political and regulatory environment which is shaping a more hostile approach to "offshore financial centres".

- the complete lack of harmonisation across the EU in relation to the requirements for managing and marketing of unregulated funds. In recent years the Commission has been lobbied by industry to introduce a harmonised regime for the private placement of funds, and has convened various groups of experts to advise it on the single market implications of a patchwork of national securities marketing laws.

There is a vast amount of lobbying to be done to make sure that the Directive does not do irreparable and unjustifiable harm to the alternative fund industry. Whilst the political case clearly has to be fought, this is not the only angle. The other concerns which are behind the legislation need to be recognised and the case made that the Directive proposals are not the right way to deal with them.

Comment

The Commission proposes a "one size fits all" approach, with additional requirements for fund managers who use "high levels of leverage on a systematic basis" or whose funds acquire more than 30% of voting rights in companies. As drafted, the proposal would give rise to significant costs for fund managers (and therefore investors) and would not fit with the commercial and practical realities of marketing and operating different types of fund.

The proposed capital requirements would be likely, if implemented, to bring about the closure or merger of many existing fund managers in some sectors (for example, private equity) and would constitute a significant deterrent to new entrants and therefore to competition.

Perhaps most damning of all, the measures would not prevent hedge funds from trading in European securities or private equity firms from investing in EU companies. The Directive would simply encourage them to do so from outside the EU and therefore beyond the control of the EU authorities, in return for not marketing their funds to EU investors. Meanwhile, EU banks, sovereign wealth funds, oligarchs and other non-fund market participants will be permitted to operate from within the EU and to invest in anything, no matter how large a company or how politically sensitive the investment, without any requirement as to transparency as to their ownership or intentions and without any restriction on their use of leverage, short selling or otherwise.

The Impact Assessment produced by the European Commission is a weak and contradictory document which has all the hallmarks of attempting to justify a position already reached for political or other reasons. It singularly fails to make a convincing connection between the various sectors of the alternative fund management industry, the perceived mischief and the proposed remedies.

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PART A

1. Scope

The Directive leaves considerable room for uncertainty in relation to its scope: many provisions are unclear and some provisions appear contradictory. In this note we set out our current understanding of the draft, informed by the Commission's Impact Assessment and Frequently Asked Questions documents. This is the beginning of a long process of negotiation and clarification.

The current draft of the Directive appears to regulate three key aspects:

(a) alternative investment fund managers;

(b) the marketing of alternative investment funds; and

(c) the provision of services to alternative investment funds by third parties.

1.1 Alternative investment fund managers

The Directive regulates "alternative investment fund managers" ("AIFM"), defined as a person who manages an "alternative investment fund" ("AIF"). The Commission indicates that this is because the responsibility for almost all decision-making in relation to the management of the fund lies with the manager. In this regard it refers not only to investment decisions but also the management of relations with investors and the organisation of administrative functions, including valuation and safekeeping. Thus by "manager" the Commission seems to have in mind the entity with the direct responsibility to investors for the management and administration of the fund. In UK terminology, it is the fund "operator". There are many entities in the EU who have responsibility for the management of large parts of hedge and other fund portfolios, but who are not the "manager" of the fund in this wider sense.

The definition of "alternative investment fund" appears to include co-investment and carried interest schemes, investment trusts and VCTs as well as all non-UCITS investment funds (no matter where established). The Directive does not, however, apply to the management of pension funds or to managers of non-pooled investment vehicles "such as endowments or sovereign wealth funds or assets held on own account by credit institutions, insurers and reinsurers, or to actively managed investments in the form of securities, certificates, managed futures or index linked bonds". It isn't clear on what basis the Commission has concluded that no sovereign wealth fund is a pooled vehicle nor what has led them to the policy conclusion that SWFs and EU banks should be exempted.

Thus we consider that the current scope and impact of the draft is as follows:

1.1.1 EU-based managers

The only entity in the EU permitted to manage and administer an AIF is a manager whose head and registered office is in an EU Member State and who is authorised under the Directive, unless one of the limited exceptions applies. This is regardless of where the fund is established.

An AIFM authorised in one EU State is able to provide management services to an AIF domiciled in another EU State by using a passport under the Directive. It can provide the services either from its home State or by establishing a branch in the EU State in which the fund is domiciled. The mechanisms for using the passport are described later in this note.

The principal exceptions are for:

(a) managers where the fund portfolios under management do not in total exceed €500million, provided that those funds are not leveraged and that investors have no redemption rights for five years from initial constitution of each fund;

(b) managers where the fund portfolios under management do not in total exceed €100million (including assets acquired through the use of leverage);

(c) managers who manage only funds which are not domiciled in the EU, provided that the funds are not marketed in the EU; and

(d) EU banks and EU insurance companies.

(There are uncertainties in relation to both value limits (a) and (b), including: (i) it is not clear how the €500m limit applies to funds which are not themselves leveraged, but have leverage at the investee company level; (ii) it is not clear whether portfolio size is to be calculated on a gross or net basis and on a committed capital or NAV basis; and (iii) neither level addresses fluctuations in asset values, which could severely limit the usefulness of the exemptions.)

Exempted managers have no rights under the Directive and cannot therefore use the marketing passport (see below) to market their funds. Those exempt under paragraphs (a) and (b) above will, however, be permitted to "opt in" so that they can have the passport, but they must then comply with the requirements of the Directive.

1.1.2 Non-EU based managers

Managers which do not have their head and registered office in an EU State cannot become authorised as an AIFM under the Directive (although they may be entitled to a licence to market their funds - see below).

1.2 Marketing the alternative investment fund

1.2.1 EU funds

EU funds can only be marketed in EU Member States to professional investors if there is an AIFM authorised under the Directive, in which case they can be marketed: (a) by that AIFM; or (b) by a MiFID investment firm.

1.2.2 Non-EU funds

For the first three years after the Directive comes into force, a non-EU fund may continue to be marketed in an EU State if permitted by the laws of that State. After that, interests in a non-EU fund can be marketed to professional investors in all EU States:

(a) by the authorised EU AIFM of that fund if the non-EU country in which the fund is domiciled has agreed to comply with OECD standards on exchange of tax information;

(b) by its AIFM established outside the EU if that manager obtains a special authorisation (see below); or

(c) by a MiFID investment firm if the fund is managed by an AIFM who falls within (b) or (c).

EU States will be able to authorise AIFMs established in non-EU countries (e.g., the U.S.) to *market* funds in the EU. Such special authorisation can only be given if the EU Commission has decided that:

(a) the prudential regulation and ongoing supervision of managers in the relevant country are equivalent to those under the Directive and are "effectively enforced";

(b) EU managers have effective and comparable market access in that country; and

(c) that country has agreed to comply with OECD standards on exchange of tax information.

There will clearly be some difficult political issues in connection with the assessments of equivalence and reciprocity. Notably, equivalent "prudential regulation" implies that the relevant country will impose regulatory capital requirements on managers: this would be a significant departure for the U.S.

1.2.3 The marketing passport

The Directive permits an AIFM authorised under the Directive to market its AIFs to professional investors in all EU States. For the purposes of the Directive "professional investor" has the narrower meaning under MiFID. This means that firms will not be able to treat as professional a prospective investor solely on the grounds of knowledge and experience. Prescriptive quantitative tests will need to be met. This will rule out marketing to most high net worth or sophisticated individuals.

Each State can decide if it permits marketing more widely and impose conditions if it does: there is no passport for marketing to retail investors. The mechanisms for using the passport are described later in this note.

1.3 Provision of services in respect of alternative investment funds by third parties

1.3.1 Where there is no AIFM authorised under the Directive

The Directive appears to state that other EU investment firms authorised under MiFID can only provide investment services in respect of funds, if the fund can be marketed under the Directive, i.e. if it has an AIFM authorised under the Directive. There are at least two possible interpretations of this provision, both of which are serious.

One would prohibit advisors from recommending units in a fund with no AIFM under the Directive to EU investors or arranging their subscription through discretionary portfolio mandates or otherwise.

The other interpretation would, on a worst case, appear to prevent any EU investment firm from providing any investment service to such an AIF (including acting as broker, adviser or placement agent), even if that AIF does not wish to market its shares or units to EU investors. It would also mean that an investment manager falling outside the Directive (for example, because it does not provide administrative services and so is not treated as an AIFM) could not manage part of a fund in the EU, unless that fund has an AIFM authorised under the Directive.

1.3.2 Where there is an AIFM authorised under the Directive

Where there is an AIFM authorised under the Directive, we believe the effect of the current draft is that the AIFM can, subject to meeting the onerous requirements set out later in this note, delegate certain functions to third parties.

2. Implementing measures

In almost all cases, the specific requirements of the Directive can be supplemented by further "Implementing Measures". These measures are likely to set out more detail, including as to both content and timing. In relation to some previous directives, the implementing measures have included material provisions.

PART B

Part B of this note describes the detailed requirements applicable to the AIFM. Those requirements will certainly apply to an AIFM based in the EU. It is not clear to what extent the Commission will expect similar requirements to be imposed on a fund manager outside the EU by a third country recognised as "equivalent" (see the special authorisation regime described in paragraph 1.2.2 above).

3. Capital requirements

The Directive imposes capital requirements by requiring the fund manager to maintain a minimum level of *own funds*. There is no capital requirement on the fund itself.

As with the current FSA regulatory capital rules applicable to investment managers, the requirement is not to hold money in a bank account, but rather that capital should be retained in the fund manager. Capital essentially means "shareholder funds" (after deducting any losses and intangible assets such as goodwill). LLPs may treat capital contributions as own funds if the LLP agreement imposes significant restrictions on withdrawal and repayment of capital.

The requirement is that own funds must be the higher of:

(a) one-quarter of fixed annual overheads, including salaries, guaranteed bonuses and rent; and

(b) €125,000 plus 0.02% of the amount by which the total value of alternative investment fund portfolios under management exceeds €250 million.

The formula is based substantially on the capital requirement imposed on managers of UCITS funds (European funds intended to be suitable for retail investors). Significantly, the UCITS legislation provides an absolute cap on the capital requirement at €10m, but there is no equivalent cap proposed for managers of alternative investment funds.

The Commission considers it is necessary to impose these requirements in order to: (a) ensure the continuity and regularity of management services; and (b) cover the potential exposure of the manager to professional liability in respect of all of its activities. This second motivation is novel because the traditional view amongst regulators is that capital requirements for investment managers should support an orderly winding up of the manager and the transfer of its functions to an alternate. Such requirements are therefore commonly calibrated by reference to a multiple of the manager's fixed expenses over a suitable run-off period (for example three or six months' money). However, it is very unusual to seek to address professional liability risk by means of extra capital. This is usually the function of professional indemnity insurance. The industry may therefore wish to try to negotiate a more proportionate capital formula, in exchange for a requirement to disclose to investors the level of professional indemnity insurance they hold.

4. Conduct of business requirements: general principles

There are three general principles requiring the fund manager to:

(a) act honestly with due skill, care and diligence and fairly in conducting its activities;

(b) act in the best interests of the fund, the investors in the fund and the integrity of the market; and

(c) ensure that all investors are treated fairly.

There is considerable overlap between these principles and the Directive's more detailed provisions (see below).

The requirement on the manager to act in the best interests of the fund may seem unremarkable at first. However, it is potentially very significant. There is a conflict in a requirement to act at all times in the interests of the fund, in the interests of investors and in the interests of the integrity of the market. These are three very different constituencies and their respective interests may frequently be mutually exclusive. In particular, whilst the interests of investors collectively may be equated with the interests of the fund, their individual interests may diverge, for example when one investor wishes to redeem or reduce their commitment. What about the classic case of a manager operating more than one fund with overlapping investment objectives? MiFID lays down requirements on the manager to allocate investment opportunities fairly but there is no equivalent provision in this proposal. There is implicit recognition that the obligations cannot each be absolute, in the requirement elsewhere to identify, manage and disclose conflicts of interest. It is to be hoped that these issues will be recognised expressly at least in a new recital and perhaps also in implementing measures.

No investor may obtain a preferential treatment over any other, "unless this is disclosed in the [fund] rules or instruments of incorporation". It is not clear whether this is a requirement to disclose the possibility that some investors may be given preferential treatment, or to disclose the nature of the preference. It may be that the requirement will be clarified through implementing measures. In any case, there is a more prescriptive obligation later in the Directive (see paragraph 13.2 below).

5. Conflicts of Interest

The manager must take all reasonable steps to identify conflicts of interest:

(a) between the manager (including its employees and controllers) and fund investors; and

(b) between one investor and another.

The manager must operate effective systems and controls designed to prevent conflicts from adversely affecting the interests of the fund and investors. The manager must disclose the general nature and sources of conflicts of interest to investors if those arrangements are not sufficient for it to be confident that risks of damage to investors interests will be prevented.

This regulatory obligation does not accurately reflect the nature and range of fiduciary duties which would be owed by a fund manager under English law but it is broadly the same obligation as UK firms are already subject to under MiFID and FSA rules.

The manager must segregate within its own operating environment tasks and responsibilities which may be regarded as incompatible with each other.

6. Risk management

6.1 The manager must:

(a) separate tasks and responsibilities for risk management and for portfolio management;

(b) implement risk management systems to measure and monitor the risks associated with each fund investment strategy and to which each fund is exposed and stress test the risks associated with each investment; and

(c) follow a documented and regularly updated due diligence process for investment.

Under MiFID, firms are required to have separate compliance, risk and internal audit functions – but only where this is proportionate to the nature, scale and complexity of their business. There is no such subtlety in the current proposal, which may be a significant concern for smaller managers, in particular.

7. Naked short selling

A manager who short sells on behalf of a fund is required to have procedures which enable it to access the securities on the settlement date and have risk management procedures designed to manage the risks associated with short selling.

This does not appear to operate as an absolute ban on "naked " short selling, but it is likely that it will require managers to have at least located the stock or taken some other steps to ensure settlement within the normal cycle.

Funds are not the only short sellers in the market and the Commission is considering short selling as a more general matter in its review of the Market Abuse Directive. However, the Directive pre-empts this by imposing risk management and transparency requirements (only) on alternative investment managers who engage in short selling.

8. Liquidity management

The manager must:

(a) adopt appropriate liquidity management procedures to ensure that the liquidity profile of investments complies with the fund's "underlying obligations";

(b) regularly conduct stress tests and monitor the fund's liquidity risk; and

(c) ensure that each fund has a redemption policy appropriate to its liquidity profile.

All managers will need to consider carefully their fund's "underlying obligations". Subject to that, this measure is likely to be relevant principally to managers of open-ended funds who will be required to prevent a mis-match between the frequency of investor redemptions and the illiquid nature of the portfolio.

The Commission will be required to adopt implementing measures which specify the minimum liquidity requirements for funds which redeem their units or shares more often than half-yearly. It remains to be seen whether this could be applied in a way which is inimicable to the maturity transformation role performed by some hedge funds, and by some funds of hedge funds.

9. Investing in securitised investments

There will be restrictions on investment in securitisations. The Commission is obliged to lay down requirements which must be met by originators before the manager of an alternative investment fund can invest the fund in a securitisation. This will include a requirement that the originator retain at least a 5% net economic interest.

The Commission will impose additional requirements on funds which invest in these securities. These are likely to reflect the due diligence and risk assessment requirements expected to be imposed on EU credit institutions through a new Article 122a to the Banking Consolidation Directive (2006/48/EC).

10. Appointment of an independent valuer

An AIFM must ensure that its funds have a valuer, independent of the manager, responsible for valuing fund assets and fund units. All assets and units of the fund must be valued at least annually and each time shares or units are issued or redeemed.

The manager must ensure the valuer uses existing appropriate and consistent valuation standards to value the fund assets in order to reflect the net asset value of the fund units.

The rules for valuation and for calculating the net asset value per unit must be laid down in the law of the country where the fund is established or in the rules of the fund or instruments of incorporation.

Three years after the Directive is implemented, non-EU valuers will only be permitted if the Commission has determined that the valuation standards and rules in the relevant country are equivalent to those in the EU.

11. Appointment of an independent custodian

A separate custodian must be appointed to have safekeeping of the monies and financial instruments belonging to the fund. The custodian must also verify that the fund (or the manager on behalf of the fund) has obtained the ownership of all other assets the fund invests in, and is obliged by the Directive to act independently and solely in the interests of investors. Perhaps because it undertakes these additional regulatory functions, the custodian is referred to in the Directive as a "depositary" (a term borrowed from the UCITS Directive).

The fund manager is not permitted to have custody of money or financial instruments. This cuts across many structures in use where the fund manager also provides custody. It may prevent assets being registered in the name of the general partner of a limited partnership, for example. There will therefore be significant changes to the custody structures for many funds – likely requiring investor consent – and additional cost for investors.

The custodian must be a bank with its registered office in the EU. There are many entities which are authorised to provide custody within the EU which would not meet these requirements. European branches of US or other third country banks cannot be depositaries.

The impact on typical hedge fund prime brokerage arrangements may also be significant. Not many established prime brokers are EU banks.

The custodian must be an EU bank even if the fund is non-EU.

A custodian may generally only delegate to another EU bank.

Three years after implementation, it will be possible to delegate to a sub-custodian which is not an EU bank but only:

(a) in respect of a non-EU fund;

(b) to a sub-custodian in that fund's jurisdiction; and

(c) if the Commission has determined that the prudential regulation, supervision and standards of the country of the sub-custodian are equivalent to those imposed by the Directive.

The fact that it will be impossible to delegate to a non-EU custodian in respect of an EU fund may impede the fund's ability to invest outside the EU, for example because the principal custodian may not be a member of the relevant local securities depository. In some jurisdictions, title to certain assets can by law only be held by a local custodian. Most established custodians currently rely on intermediated sub-custody networks.

There is specific provision about the liability of the custodian. It will be liable to the fund and investors for any losses suffered by them as a result of its failure to perform its obligations. If it loses financial instruments it will have to prove that it could not have avoided the loss which has occurred.

The custodian is also to be liable for delegates, which may be a further significant impediment to sub-custody networks.

12. Delegation by the fund manager

There are extremely onerous requirements on a manager which intends to delegate to someone else the task of carrying out any of its functions. Its functions include not only portfolio management but also administration and marketing. It appears therefore that the provisions would extend to the appointment of third party administrators and placement agents.

The fund manager must obtain prior authorisation from its regulator for each and every delegation on a case-by-case basis.

This creates significant moral hazard for EU regulators.

The manager's liability will not be affected by delegation and it must not delegate so much that it is in effect no longer really the manager of the fund. The Commission is empowered to make implementing measures to clarify how far delegation can go.

Where portfolio management or risk management is delegated then it can only be delegated to another fund manager authorised under the Directive to manage a fund of the same type. This would prevent funds with a geographical investment focus outside the EU delegating some management to a local regional manager.

In the case of any delegation the third party must be creditworthy and the people who conduct its business must be of sufficiently good repute and sufficiently experienced.

The manager may only delegate administrative functions to an entity based outside the EU if that third party is authorised to provide administration services or registered in its country and is subject to prudential supervision, and there is a co-operation agreement with its regulator.

The fund manager must demonstrate that any delegate is qualified and capable of undertaking the functions in question, and that it was selected with due care. The manager must be able to monitor the delegate effectively, to give further instructions and to withdraw the delegation with immediate effect when this is in the interests of investors.

The third party may not sub-delegate.

These requirements in relation to delegation are far greater than those that apply to portfolio managers under MiFID, including those portfolio managers who have retail clients.

13. Transparency requirements – disclosure to investors and regulators

The transparency requirements are divided into: (a) the requirement for an annual report; (b) investor reporting; and (c) reporting to regulators.

13.1 Annual report

An annual report on each fund must be made available to investors and to regulators within four months of the end of the financial year. It does not appear that the report need necessarily be made public.

The annual report must include a balance sheet or statement of assets and liabilities, a detailed income and expenditure account, a report on activities, as well as any significant information which will enable investors to make an informed judgement on the development of the activities of the fund and its results. There are supplementary requirements where the manager has a controlling influence in an investee company (see below).

The accounting information must be audited by an EU auditor (which may be odd if the fund vehicle is domiciled abroad and subject to non-EU accounting requirements).

13.2 Disclosure to investors

The manager must provide investors with certain information prior to their investment and regularly update it. Most of this information is probably not exceptional, although note the following requirements to:

(a) describe all risks associated with the fund's assets and investment techniques;

(b) describe the legal implications of the contract of investment, including information about jurisdiction, applicable law and the existence (or not) of laws providing for the recognition and enforcement of judgments in the jurisdiction in which the fund is domiciled;

(c) describe the circumstances in which the fund may use leverage and the types and sources of leverage;

(d) describe the fund's valuation procedure including the methods used in valuing hard-to-value assets; and

(e) describe all fees, charges and expenses and the maximum amounts of them which are directly or indirectly borne by investors.

Significantly, the manager must also identify any investor who has obtained, or who has a right to obtain, a preferential treatment, and must describe the nature of the preferential treatment. This might be through side letters or side pocket arrangements. There is apparently no materiality threshold, although a threshold could be introduced through implementing measures.

For each fund there must be periodic disclosure of the percentage of the assets which are subject to special arrangements arising from their illiquid nature (such as side pocket arrangements), the risk profile of the fund and the manager's risk management systems.

13.3 Reporting to competent authorities

The manager will be obliged to report a considerable amount of information to its regulator including:

(a) the principal markets and instruments on and in which it trades;

(b) the principal exposures and most important concentrations of each of the funds it manages;

(c) the main categories of assets in which the funds are invested;

(d) on the use of short selling during the reporting period;

(e) a list of its funds; and

(f) a copy of the annual report on each fund.

The Turner Report, which analysed the causes of the financial crisis and suggested the way forward, identified a need for regulators to have more extensive information on hedge fund activities and on the activities of any other emerging form of investment intermediation, in order to inform their macro-prudential analysis.

14. Requirements on managers of leveraged funds

Specific obligations apply to managers of funds which employ high levels of leverage on a systematic basis.

A manager is required to assess quarterly whether a fund it manages employs "high levels of leverage on a systematic basis" and to notify its regulator if this is the case.

“High levels of leverage on a systematic basis” are considered to arise when the combined leverage from all sources exceeds the value of the equity capital of the fund on two out of the past four quarters.

"Leverage" is poorly defined, in the current draft as "any method by which the manager increases the exposure of a fund it manages to a particular investment whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means".

These provisions appear to be directed at hedge funds where the fund is a direct borrower. It is not thought that transactions where the leverage is at investee level are intended to be caught, although this is not clear. If not, this clearly opens up the possibility for avoidance by hedge funds who could establish special purpose vehicles for the purposes of taking leverage.

Fund managers who fall within these provisions are required to disclose to investors:

(a) the maximum level of leverage which the manager may use as well as any right of re-use of collateral or any guarantee granted under the leveraging arrangement; and

(b) on a quarterly basis, the total amount of leverage employed by the fund in the preceding quarter.

Fund managers who fall within these provisions are also required to disclose to their regulator on a "regular" basis:

(a) information about the overall level of leverage employed by each fund, with a break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives; and

(b) the five largest sources of borrowed cash or securities for each of the funds and the amounts of leverage received from each of those sources for each of the funds managed by the manager.

The information provided to the regulator is intended to assist it in identifying the extent to which leverage contributes either to the build up of systemic risk or to the risk of disorderly markets. The manager's regulator is required to aggregate the information it receives in respect of all the managers that it supervises and make it available to other EU regulators. It is also required to notify other regulators if a manager under its responsibility could potentially constitute an important source of counterparty risk to a bank or other systemically relevant institution in their Member State.

The Commission will be required to adopt implementing measures to set limits on the level of leverage funds can employ, taking into account the type of fund, its strategy and the sources of its leverage.

There is a reserve power for Member States, in exceptional circumstances to impose additional temporary limits on the level of leverage funds may employ. It is not clear what their competence is to be in respect of the territoriality of these limits. Again, there is a moral hazard risk for regulators.

15. Requirements on managers who acquire 30% voting rights in companies

If a fund manager manages one or more funds which either individually or in aggregate account for 30% or more of the voting rights of a listed or non-listed company domiciled in the EU, or has an agreement with other managers which would allow the funds managed by them in aggregate to acquire 30% or more, then it is subject to a range of disclosure requirements. "Listed" in this section refers to a company whose securities are admitted to trading on an EU regulated market.

The only exception is for investees which employ fewer than 250 people, have an annual turnover not exceeding €50 million and/or an annual balance sheet total not exceeding €43 million.

Some larger real estate transactions structured using corporate "wrappers" may exceed the size thresholds.

If the holding is in a *listed company* the manager must make available to the company, its shareholders and employee representatives:

(a) certain information required under the Takeover Directive (in essence, the full offer document);

(b) its policy for preventing and managing conflicts of interest, in particular between the fund manager and the company; and

(c) its policy about how it communicates with stakeholders, in particular as regards employees.

The manager is required to provide the following information to *unlisted companies*, their shareholders and employee representatives:

(a) within four trading days of acquiring the position, the resulting situation in terms of voting rights; the conditions under which the 30% threshold was reached, including information about the identity of the different shareholders involved; and the date on which the threshold was reached or exceeded;

(b) the identity of the manager(s) which have triggered the requirement;

(c) the development plan for the unlisted company;

(d) its policy for preventing and managing conflicts, in particular between the fund manager and the unlisted company; and

(e) its policy about how it communicates with stakeholders, in particular as regards employees.

The reference to a policy for managing conflicts "between the fund manager and the company" is extremely concerning. It implies a huge shift towards the law requiring shareholders (at least particular types of shareholder) to owe obligations to companies in which they invest. Whilst a director appointed to the board of the investee company will owe duties (to be managed in accordance with ordinary company law principles), a shareholder does not ordinarily owe a duty to the company to act in its interests.

Where there is no employee representative, for both listed and unlisted companies, the relevant information must be provided to all employees.

In addition, the annual report published by the manager of the relevant fund(s) must contain further information in relation to each listed and unlisted company in which the fund has a controlling interest. This information must include:

(a) operational and financial developments;

(b) a presentation of revenue and earnings by business segment;

(c) a statement on the progress of the company's activities and financial affairs;

(d) an assessment of expected progress on activities and financial affairs;

(e) a report on significant events in the financial year;

(f) financial risks associated with capital structure;

(g) data on turnover, terminations and recruitment of employees;

(h) statement on significant divestment of assets;

(i) in respect of *listed companies*, the composition and operation of the administrative, management and supervisory bodies and their committees; prescribed details relating to the capital structure; and the holders of any securities with specific control rights and a description of those rights; and

(j) in respect of *unlisted companies*, an overview of the management arrangements; the nominal value and number of shares subscribed, in total and by class; the rights attaching to each share class; where relevant, any provisions relating to conversion of shares from bearer to registered form; the amount of subscribed capital paid up at the time the company is incorporated or authorised to commence business; and the nominal value or number of shares paid up other than in cash, with details.

16. Public to private transactions

For two complete financial years following its withdrawal from the regulated markets, an issuer which is delisted must continue to fulfil requirements applicable to a listed company, which derive from the Transparency Directive, to publish annual and half-yearly public accounts.

17. Marketing procedures

Before the manager can market a fund to professional investors in its own EU State it must first provide its regulator with certain information about each fund that it intends to market. The regulator may impose restrictions or conditions on the marketing.

The manager's regulator must inform the manager within ten working days whether it may commence its activities. However, if the fund is established in a third country the regulator is entitled to take longer if necessary to be satisfied that the conditions imposed by the Directive have been met.

Member States have the option to allow funds to be marketed to retail investors in their country and to impose stricter requirements on the fund or the manager if they allow it at all.

Once authorised, the authorisation is valid for all Member States. There is a requirement for authorisation to be granted or refused within two months of submission of a complete application. Note that the FSA currently has six months to determine an application for authorisation.

18. Marketing cross-border

The manager must notify its own regulator of its intention to market a fund to professional investors in other Member States, together with certain documents and details about the fund. These need not necessarily be translated if they are in a "language customary in the sphere of international finance". The manager's own regulator must transmit this within ten working days of receipt to the relevant authorities of the Member State where the fund will be marketed and notify the manager that it has done so. The manager can only market cross-border from the date it receives this notification.

The marketing arrangements in the other Member State has to be in accordance with its laws. It appears that the host member state may have some supervisory role although this is not clear.

Any change to the particulars that have been provided must be described to the manager's own regulator at least one month before implementing the change. Since this would include changes to documents such as the PPM, this does not fit with the established approach to private placement.

19. Managing cross-border

There is also a passport right to enable a fund manager authorised in one Member State to manage a fund established in another Member State using its home authorisation. It should be noted that this concept has caused significant difficulties in connection with UCITS, where other Member States have sought to obstruct the exercise of such rights.

PART C: KEY ISSUES

At this stage almost every provision of the Directive gives rise to concerns. Our thoughts on those aspects which are likely to emerge as priorities are as follows:

- The possible restriction on all EU investment firms from providing services in respect of AIFs which do not have an AIFM authorised under the Directive is very serious. It is disproportionate and likely to be of huge international concern. There is a real possibility that, if this provision prevails, "fortress Europe" will have been established with significant consequences for the international markets.
- The concept of equivalence and reciprocity for non-EU firms to have the special authorisation for marketing AIFs in the EU is also extremely difficult. The nature of the rules in relation to which there must be equivalence is not clear and whether the equivalence test is satisfied is likely to become a deeply political decision. In essence, the Commission appears to be trying to pre-empt the work being undertaken by G20 and IOSCO – a strategy which may back-fire.
- There is no logical rationale for exempting EU banks (and therefore, indirectly, the funds operated by them) from the requirements of the Directive. This means they will be free to operate their funds – and promote them to EU investors – outside the restrictions imposed by the Directive. Why should two firms conducting identical business in relation to investment funds be treated differently?
- There is considerable uncertainty as to the impact of the Directive on private placement regimes in EU States. This will need to be clarified.
- The extensive use of powers to make further implementing measures is concerning. The draft follows the approach of a relatively high level Directive which confers further powers on the Commission to make more detailed legal provision as "Level 2" legislation. The theory is that this permits greater flexibility in making detailed changes because Level 2 legislation may be easier to amend, though in practice there will still be enormous resistance to changing legislation. Almost every provision allows or requires the Commission to make further measures and it can be assumed that if it has the power to do so it will. A similar structure is found with MiFID, where the main Directive is supplemented by a further Implementing Directive and a Regulation. These contain excessive amounts of detail and, in the case of the Regulation, are directly binding. Such provisions inhibit flexibility and market development and usually assume that “one size fits all”, which in a Directive which covers every type and constitution of fund is unrealistic. Those areas where the use of such a power is the most objectionable must be raised at an early stage.
- The requirement to have an independent custodian is disproportionate for some fund types (for example, no issues have arisen with custody of private equity investments, and there is no case made as to why there should be such a requirement). It might not be capable of being given effect in some existing funds where the custody arrangements will be part of the agreement and all investors might need to consent to the change. It will impose additional expense on the fund which will be borne by the investors.
- The requirement for an independent valuer will in many cases be inappropriate. For example, in the case of a private equity fund, the imposition of the independent valuer will result in the replacement of the person who does understand the investment with someone who does not. This will not improve investor protection because, in a closed-ended fund, the investor does not get any "value" until investments are actually realised, at which point their value becomes clear.
- There are a number of provisions which will be onerous for regulators as well as firms and there is no case for them. For example, the requirement that all delegations of management, administration or marketing must be approved by the regulator on a case-by-case basis. In the UK, the FSA would be deluged with requests for approvals, and these provisions give rise to reputational risk for the regulator, for example if they approve a delegate against whom investors subsequently have a complaint.
- The concept of leverage is inadequately defined, for example, the provisions on leverage are presumably intended to affect the use of leverage at fund level, but this is not at all clear. A decision needs to be made as to whether clarification should be sought at this stage.
- The requirement for the Commission to set a limit on leverage is concerning and must be monitored on a number of levels. In particular, if the justification for a leverage limit is financial stability, there is no reason for imposing a limit on AIFs if an equivalent limit is not also imposed on all other market participants. The huge failures which have rocked the markets have been investment bank failures, not fund failures.
- Some of the requirements are ill-considered and there will need to be a lot of work to give them appropriate scope either in the Directive or the implementing measures. Examples include: (a) the requirement for managers to act in the best interests of the AIF, its investors and the integrity of the market, whereas in practice the assessment is more subtle and permits the manager to take into account other quite proper considerations; and (b) the arrangements for dealing with conflicts of interest when a controlling stake is acquired. There is considerable uncertainty as to what this means, but at its worst it appears to suggest that duties are owed to investee companies and could therefore conflict with the AIFMs obligations to the fund and its investors etc.
- There are major transitional issues. It is assumed that this Directive would affect existing funds under management as well as funds raised after it comes into force. The terms of these funds have been negotiated with investors and some of the issues may well require changes to existing arrangements which need to be contractually agreed, the scale and time needed for this could be significant.
- The requirements for prior marketing notifications are onerous for firms and regulators and do not reflect the commercial reality of an iterative marketing process and assume that documentation is always in final form before marketing commences.

We will be continuing to provide input into the process and monitor developments for clients, including, as the proposals solidify, advising on the impact on particular fund structures and suggesting possible alternative structures.

If you would like further information or advice on these matters, please contact Margaret Chamberlain, Jane Tuckley or Tim Lewis in the Financial Services and Market Department or your usual contact at Travers Smith.

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12 May 2009

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