

EU Alternative Fund Regulation Proposal: Pros and Cons

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On 30 April 2009, the European Commission published its proposal for a Directive on Alternative Investment Fund Managers (AIFMs).¹ The new regulatory proposal will apply to hedge fund and private equity managers, as well as those managing other 'alternative' funds such as commodity and real estate funds. The proposed rules follow heavy pressure from world leaders – most recently at the G20 – to extend regulation and oversight to all relevant players in the financial markets, including alternative funds, in order to identify systemic events at an early stage. However, while the hedge funds industry reacted relatively mildly to the proposal, it was immediately attacked by the private equity industry as being illogical and disproportionate.² The reaction of the Party of European Socialists (PES) President Poul Nyrup Rasmussen was also not so positive, saying that 'This directive has more holes than a Swiss cheese.'³ On the other hand, the conservative EPP-ED Group has been very supportive with their fellow party member McCreevy, the European Union (EU) internal market commissioner and the architect of the AIFM proposal. According to EPP-ED, the proposal can be considered a good step in the right direction.⁴ So what does the proposal entail and what are the pros and cons?

The proposal aims to create a comprehensive and effective regulatory and supervisory framework for AIFMs. In short, the proposed directive will require alternative managers to be registered and to be subject to harmonized regulatory standards on an ongoing basis. Under the proposal, managers of alternative funds with assets under management above EUR 100 million (or EUR 500 million for managers with no leverage and a lock-in period of five years or more) must apply for authorization with the competent authorities of the EU Member State where they have their registered office (*home state control*).⁵ This would be granted within two months if the regulatory authorities are

satisfied that the manager fulfils the conditions of the Directive. In this authorization process, AIFMs would be required to provide information on the identities of their fund members and the characteristics of the alternative funds they intend to manage. In addition, they would be required to ascertain, among other things, that they meet minimum capital requirements (EUR 125,000 plus 0.02% of the amount by which the value of the portfolio exceeds EUR 250 million), have implemented sufficient risk management procedures, are adequately managing and disclosing conflicts of interest, ensure fair valuation of assets by an independent valuator, ensure that investors receive relevant and sufficient information, and secure depository/custodian arrangements to ensure safekeeping of assets.⁶ Once authorized, the AIFM is entitled to market its funds to professional investors across the EU, subject to only a notification procedure. Under this procedure, relevant information must be provided to the home regulator, which will send the information to the regulators in the other states where the fund will be marketed.⁷

Is the AIFM proposal, the first of its kind in the world, a step too far or is it not going far enough? On the plus side, the proposal enables AIFMs to market their funds to professional investors in any Member State. Managers of alternative funds cannot market their funds under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive,⁸ which provides a regulatory framework and an EU passport for traditional (UCITS) funds. The industry has long been calling for a level playing field between investment funds by enabling fund managers to market hedge funds, property funds, and other non-UCITS funds across border to professional investors. However, what they did not call for is stringent regulation when they operate in the EU. Since most of these managers rely upon regulatory exemptions in national laws (mostly exemptions for offerings

1 Commission of the European Communities, Proposal for a Directive on Alternative Investment Fund Managers, 30 Apr. 2009, COM (2009) 207 final.

2 See European Private Equity and Venture Capital Association (EVCA), 'Statement on Proposed EU Directive on Alternative Investment Fund Managers', <www.evca.eu/>, 29 Apr. 2009.

3 European Socialist Party, 'Draft Directive Has More Holes than Swiss Cheese', <www.pes.org/>, 29 Apr. 2009.

4 Jean-Paul Gauzès, EPP-ED coordinator in the Parliament's committee on economic and monetary affairs, 'Hedge Funds: Commission Going in the Right Direction, at Last', <www.epp-ed.eu/>, 29 Apr. 2009.

5 See Art. 2.

6 See Arts 4–8.

7 See Art. 33 for the complete procedure.

8 Council Directive 85/611/EEC of 20 Dec. 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended, *inter alia*, by Directives 2001/107/EC and 2001/108/EC, OJL 375/3, 31 Dec. 1985.

to professional investors only), they are generally not regulated or lightly regulated. In this perspective, it is not surprising that the fund management industry is not so happy with this proposal, which would mean a huge interference in the way they run themselves. The Commission, however, believes that regulating AIFMs will enable regulators to more adequately address the risks of these funds. However, is this the right way to do this? Although the Directive may help regulators to detect systematic risks associated with these funds earlier, it may also create some problems.

A potential problem worth noting is the fact that the new regulation may create extra costs for investors. Under the Directive, investors will receive information on the fund's objectives and investment strategy, including assets in which the fund may invest, the investment techniques that may be employed, and any associated risk.⁹ In general, it can be said that more information enhances investor protection as it improves investors' knowledge about the funds they invest in. However, the question is whether investors in alternative funds really need this information. As stated above, most alternative funds are restricted to professional investors. These investors can be considered knowledgeable enough to safeguard their own interests. In addition, more importantly, more information usually also mean more fees and other costs to be paid by investors. So, in order for the proposed Directive to be really beneficial for investors, the question that should be considered is: would the extra information outweigh the extra costs that come with it?

Another important issue is the fact that the proposal emphasizes managers, rather than the funds directly. As a result of this, fund managers could quite easily avoid the rules by setting up several small funds below the regulatory thresholds of EUR 100 million – including leveraged assets – or EUR 500 million as long as those assets are not leveraged and the fund does not allow full withdrawals during its first five years of existence. In addition, fund managers from outside the EU do not fall under the proposal. The strict rules could push fund managers to relocate outside the EU, for instance in Switzerland. This would not only mean that less AIFMs than originally anticipated would fall under the Directive but also that EU alternative fund managers suffer a competitive disadvantage against those outside of Europe. Moreover, with less AIFMs registered in the EU, it would also be more difficult for regulators to detect and act on the systematic risk posed by the alternative investment industry. Other issues that should be considered in reviewing the proposal is the fact that the proposal does not contain any tax provisions or restrictions on the use of leverage, securitization, and particular investment strategies such as 'naked' short-selling. In addition, it is not clear how this regime will work in relation to listed funds that operate under the Prospectus Directive and the upcoming introduction of a pan-European private placement regime.

The proposal, which is subject to the co-decision procedure and thus needs approval of the European Parliament, is planned to enter into force in 2011. Considering the above-mentioned criticism, intense political discussion and negotiation are likely to take place before any legislation will be adopted. It is therefore questionable whether the final legislation will be ready by 2011. In any case, the legislation would be a first step forward towards regulating AIFMs, whether the industry and investors are up for it or not.

⁹ Article 20.