



# EU Commission Proposal for a Directive on Alternative Investment Fund Managers

## Key Issues for Investors in Hedge Funds and Funds of Hedge Funds

### 1. Background

- 1.1 On 30 April 2009 the EU Commission published the final text of a draft EU Directive (Directive) on Alternative Investment Fund Managers (AIFM). The Directive will apply to any AIFM established in an EU member state (EU AIFM) which provides management services to one or more alternative investment funds (AIF), whether the AIF is domiciled inside or outside the EU, whether the AIF is open-ended or closed-ended and whatever the legal structure of the AIF. In addition, the Directive will also apply to the marketing of AIF in the EU by AIFM which are established outside the EU (non-EU AIFM). AIF include both hedge funds and funds of hedge funds.

### 2. Introduction

- 2.1 The objectives of the Directive are to reduce the risks which the activities of AIFM potentially cause to investors, creditors and trading counterparties of AIF and to the stability and integrity of the financial markets. These objectives are laudable but the provisions of the Directive go considerably further than this and impose requirements designed to benefit professional investors which are more onerous than those imposed by the UCITS Directive to protect retail investors. As currently drafted, the Directive will result in a substantial reduction in choice for investors in the EU and a substantial increase in costs and hence a potentially significant reduction in investment returns.
- 2.2 At the beginning of August 2009 the Alternative Investment Management Association (AIMA) warned that the Directive could cost Europe's pension fund industry up to €25 billion per annum if implemented in its current form. More recently the UK Financial Services Authority has commissioned a cost benefit analysis of the Directive which is expected to focus, amongst other things, on the impact of the Directive on costs to AIFM and investors and on the impact on European competitiveness.

### 3. Restrictions on Choice

#### Marketing

- 3.1 The Directive provides that EU AIFM authorised under the Directive will be granted a passport to market the AIF which they manage throughout the EU to professional investors (defined to mean investors within the meaning of Annex II of the MiFID Directive). The passport is subject to a requirement that each EU member state in which an AIFM wishes to market a non-EU AIF has entered into an agreement with the country in which the non-EU AIF is domiciled to share information on tax matters which complies fully with the standards laid down in the OECD Model Tax Convention and which ensures an effective exchange of information in tax matters. It should be noted that if an EU member states wishes to restrict the marketing of non-EU AIF domiciled in a particular country, it may do so by not entering into an agreement to share information in tax matters with that country.
- 3.2 The passport to market non-EU AIF will, however, only become available three years after the date on which the legislation of the EU member states implementing the Directive is required to enter into force (the transposition date). Until then EU member states may allow or continue to allow (as the case may be) EU AIFM to market non-EU AIF to professional investors under the existing national private placement rules currently in force in those member states. It is not clear, however, whether where those national private placement rules currently permit non-EU funds to be marketed to investors who are not professional investors as defined for the purposes of the Directive, marketing to such non-professional investors will be permitted. It must also be noted that during this three year period non-EU AIF will be at a competitive marketing disadvantage when compared to EU AIF, particularly in countries such as France and Italy which do not currently allow non-EU AIF to be marketed even on a private placement basis.
- 3.3 The Directive also provides that an EU member state may authorise a non-EU AIFM to market an AIF of which it is the manager (whether it is an EU AIF or a non-EU AIF) to professional investors throughout the EU provided that five conditions are satisfied. These conditions include a determination having been taken by the EU Commission (rather than the relevant EU member state) that the legislation of the non-EU country in which the non-EU AIFM (not the AIF itself) is established in relation to prudential regulation and ongoing supervision is equivalent to the provisions of the Directive and is effectively enforced and that AIFM established in the EU are granted comparable effective market access to professional investors in that non-EU country. It seems very unlikely, if not impossible, that all of the conditions will be able to be satisfied. A more detailed discussion of the impact of the Directive on non-EU AIFM can be found in AIMA's Guidance Note on Third Country Fund Managers and in our note of Key Issues for US Managers of Hedge Funds and Funds of Hedge Funds.
- 3.4 The ability of an EU member state to authorise non-EU AIFM to market EU and non-EU AIF to professional investors in the EU will also only apply with effect from three years after the transposition date. While EU AIFM will be permitted to market non-EU AIF in the EU during this three year period under the existing private placement rules currently in force in the EU member states as described above, it is not clear whether non-EU AIFM will also be permitted to do so.
- 3.5 Critical to a consideration of these provisions is the definition of marketing. The Directive defines this to mean any general offering or placement of shares or interests in an AIF to or with investors domiciled in the EU, regardless of at whose initiative the offer or placement takes place.

It has been suggested that the definition was not intended to extend to responding to unsolicited approaches from investors, but the EU Commission has subsequently made it clear that it fully intended to capture both active marketing (by an AIFM) and passive marketing (at the initiative of the potential investor) in order to avoid circumvention of the Directive's marketing restrictions. Accordingly, if a non-EU AIFM receives an unsolicited approach from an EU investor, any response to that approach is likely to constitute marketing by the AIFM.

- 3.6 The conditions which must be satisfied in order for a non-EU AIFM to be authorised to market the AIF which it manages to professional investors in the EU in effect introduce a form of protectionism which will not benefit EU investors. The likely inability of a non-EU AIFM to satisfy the conditions will result in EU investors being substantially restricted in the choice of AIF in which they may invest. As well as reducing choice, a likely consequence is that many EU investors will have difficulty meeting their investment objectives. Moreover, if the EU effectively locks out AIF managed by non-EU AIFM in this way, non-EU countries may in turn reciprocate and lock-out AIF managed by EU AIFM from their own markets. This cannot be in the interest of EU investors. It would also contradict the terms of the Communiqué issued by the G20 in April 2009 in which it was agreed that protectionist measures would not be engaged in by the G20 countries.

#### Depositories, Prime Brokers and Liability Issues

- 3.7 For each AIF that it manages (whether it is an EU AIF or a non-EU AIF) an AIFM is required to ensure that a depositary is appointed to fulfil certain tasks. The depositary is required to be an EU credit institution and since the right of the depositary to delegate is expressed as a right to delegate to "other depositaries", it appears that sub-custodians must also be EU credit institutions.
- 3.8 The obligation to appoint an EU credit institution as depositary is stricter than the requirement under the UCITS Directive, which merely requires the depositary of a UCITS fund to be an institution which is subject to prudential regulation and ongoing supervision. Also, the UCITS Directive authorises the EU member states to determine which categories of institutions shall be eligible to be depositaries. Currently, many of the largest depositaries/custodians operating in the EU are not EU credit institutions and not all EU credit institutions act as depositaries of UCITS. This requirement will unnecessarily and significantly restrict an AIF's choice of depositary and will effectively concentrate counterparty risk in the hands of a small number of EU credit institutions, which in view of the problems which certain EU credit institutions have faced during the current financial crisis is not in the interests of investors.
- 3.9 In addition, requiring an AIF to appoint an EU credit institution as depositary will conflict with the laws in certain domiciles in which AIF are established or incorporated and which themselves require a local depositary or custodian to be appointed. Further, the majority of prime brokers on whose services hedge funds are reliant are neither EU credit institutions nor have an EU credit institution in their group. It is also becoming increasingly common for hedge funds to appoint more than one (and sometimes multiple) prime brokers with a view to reducing counterparty risk. Requiring that only one depositary be appointed and that it be an EU credit institution will make it impossible for multiple prime brokers to be appointed and will lead to a concentration of risk.
- 3.10 Given that it is standard market practice in the custody world for depositaries/custodians to appoint sub-custodians (which may be subsidiaries or other affiliates of the depositary/custodian or third party sub-custodians) of securities in the countries in which the issuers of those securities

are incorporated, that in certain jurisdictions title to securities or other assets must be held by a local sub-custodian and that no EU credit institution operates through a branch network outside the EU, the provision of the Directive requiring sub-custodians to be EU credit institutions will be unworkable.

- 3.11 The Directive imposes what is in effect strict liability on the depositary for its own failures and for those of any sub-custodians which it appoints. This is disproportionate and contradicts not only current market practice in relation to AIF but also in relation to custody generally. Depositaries are not currently compensated for the risk of strict liability and thus are likely to charge substantially more for assuming this risk (which additional cost will be borne by investors) and/or not act for certain AIF and/or not for AIF pursuing certain strategies (for example, emerging market investment strategies). This is likely to be the case whether or not the requirement that sub-custodians be EU credit institutions is removed since even if it were, it must be very doubtful whether depositaries would be prepared to accept strict liability for sub-custodians in, or which hold securities issued by issuers in, emerging market countries. This will limit the ability of AIF to invest in emerging markets, which is not in the interests of investors nor consistent with the EU's obligations to aid developing countries.
- 3.12 Where a prime broker is not itself an EU credit institution and thus cannot act as depositary, it will be necessary for the depositary of an AIF which is a hedge fund to appoint prime broker(s) as global sub-custodian(s) and in such case the depositary will have to accept liability not only for each prime broker but also for each prime broker's sub-custodian network. This is again likely to increase the fees which depositaries charge to AIF and which will be borne by investors. Further, since the demise of Lehman, many prime brokers have been developing modifications to the custody element of their prime brokerage offering, whereby assets in excess of the prime broker's margin requirement would be transferred to, and held by, a separate custodian so as to mitigate the potential for any loss that might be suffered in the event of the prime broker's insolvency. The appointment of any such separate custodian will further complicate the issues and is likely to increase the costs borne by investors.
- 3.13 The provisions of the Directive relating to depositaries, sub-custodians and prime brokers, and depositaries' liability therefor, will reduce the choice of depositaries and prime brokers (and, accordingly, reduce competition), increase counterparty risk, limit the ability of AIF to invest in emerging markets and cause some depositaries to refuse to act for AIF pursuing certain strategies or investing in certain markets as well as to increase their fees.

#### Leverage Limits

- 3.14 The Directive obliges the EU Commission, in order to ensure the stability and integrity of the financial system, to adopt measures setting limits to the level of leverage which AIFM can employ in relation to AIF, taking into account the type of AIF, their strategies and their sources of leverage. This provision has been criticised for a number of reasons, including the difficulty, if not impossibility, of defining leverage and setting appropriate limits thereon as well as the undesirability of potentially creating an unlevel playing field vis-à-vis other financial market participants. It is thought likely that if this obligation is retained, it may cause certain AIFM to have to cease marketing certain AIF in the EU or to move outside the EU with the result that they will be unable to market their AIF in the EU, thereby restricting the choice of AIF available to investors in the EU. Further, one EU member state has suggested that, if leverage limits are

imposed, investors and counterparties could be induced to reduce their normal due diligence procedures and to relax their risk management standards, which would not be in the interests of investors generally.

## Delegation

- 3.15 The Directive provides that an AIFM may only delegate portfolio management or risk management in relation to an AIF (whether it is an EU AIF or a non-EU AIF) to a third party which is itself authorised as an AIFM to manage an AIF of the same type. This obligation is more onerous than the conditions imposed by the MiFID Directive on the delegation by investment managers of portfolio management services in relation to retail clients. It will therefore prevent an AIFM from delegating part or all of the portfolio management function to an investment manager which is a specialist in a particular area, such as emerging markets, but which is not EU based and thus not subject to authorisation, or capable of being authorised, in the EU. This restriction on delegation could cause existing AIF investing in, for example, emerging markets or with global investment themes to have to close down and new AIF not to be launched. The closing off of access to the specialist skills of investment managers outside the EU is clearly not in the interests of investors.

## Side Letters

- 3.16 The Directive provides that where an investor is granted or given the right to obtain preferential treatment, not only must a description of that treatment be disclosed to all other investors, but so must the identity of the investor in question. This obligation may cause investors to disinvest from AIF managed by EU AIFM and not to invest in such AIF in future.

## Start-Up AIFM

- 3.17 The Directive requires that an AIFM must ensure that its risk management and portfolio management functions are segregated. This will be an onerous obligation for small AIFM and one with which they may be unable to comply, resulting in them being unable to obtain authorisation as an AIFM and thus being unable to market the AIF which they manage in the EU. This will impose a barrier to entry into the market for small AIFM and thus over time is likely to reduce the investment choices available to investors.

# 4. Restructuring and Compliance Costs

## Who is the AIFM?

- 4.1 It has been assumed by investment managers of hedge funds and funds of hedge funds that it is they who qualify as the AIFM for the purposes of the Directive. It is not entirely clear, however, that this in fact is the case. The Directive defines an AIFM as any person whose regular business is to manage one or several AIF and provides that it applies to all AIFM established in the EU which provide management services to AIF. Management services is defined to mean the activities of managing and administering one or more AIF on behalf of one or more investors. However, the Preamble to the Directive contains a statement that investment firms authorised under the MiFID Directive (which would include investment managers of all types) are not required to obtain authorisation under the Directive in order to provide investment services in respect of AIF.

- 4.2 It appears, therefore, that the concept of an AIFM is more akin to that of a management company of a UCITS fund under the UCITS Directive. The fact that the definition of management services refers to the activity of administering AIF, which is not normally a responsibility performed by an investment manager of an AIF, may support this contention. The UCITS Directive recognises, however, that UCITS funds may be established in the form of investment companies which are self-managed in that they do not appoint a separate management company and which themselves directly delegate functions to investment managers, administrators and depositaries. If the Directive had the effect that AIF which are investment companies and have not appointed a manager with the same responsibilities as the management company of a UCITS fund were required to restructure themselves so as to do so, this would inevitably lead to significant costs which would be borne by investors.

#### Master-Feeder Funds

- 4.3 Although the EU Commission has recognised that hedge funds are often organised in master-feeder fund structures, it is not clear how the Directive will apply to such structures and if it were to result in such structures having to be reorganised, this could result in significant costs which would be borne by investors.

#### Prime Brokers as Sub-Custodians

- 4.4 If, as described above, prime brokers to existing AIF have to be appointed by the depositary as global sub-custodians, such that existing prime brokerage arrangements have to be restructured, this will result in significant costs for investors.

#### Independent Valuation Agents

- 4.5 The Directive requires an AIFM to ensure that each AIF which it manages appoints an independent valuation agent to calculate the value of the AIF's assets and of its shares. Current market practice is for this function to be performed by a third party administrator which, however, sometimes relies on the AIFM to value certain hard-to-value assets the pricing of which the administrator then verifies. If administrators are to be required to assume responsibility for valuing all of the assets of AIF, and assuming that they are prepared to accept this responsibility, it is likely that they will wish to be compensated for the additional responsibility and these additional costs will be borne by investors.
- 4.6 In addition, as mentioned above, the definition of management services includes the activity of administering AIF and as a result, it may be necessary for the AIFM to appoint the third party administrator of an AIF (by way of delegation), whilst the independent valuation agent is appointed by the AIF itself. This could lead to existing arrangements with third party administrators having to be restructured, the costs of which would be borne by investors.
- 4.7 The Directive permits an AIF to appoint an independent valuation agent established in a non-EU country, subject to certain conditions compliance with which is to be determined by the EU Commission. However, the Directive provides that these provisions will only come into force three years after the transposition date and it is unclear whether AIF which have currently appointed non-EU valuation agents will have to replace those valuation agents with EU valuation agents during that three year period, thus resulting in existing arrangements having to be, at least temporarily, restructured at the cost of investors.

- 4.8 It has recently been suggested by at least one EU member state that the Directive should be amended to provide for AIFM to be responsible for the valuation of an AIF's assets and of its shares following the UCITS model. An AIFM would not be prevented from delegating this function to an independent valuation agent but the AIFM would retain liability vis-a-vis the AIF and its investors for the performance by the valuation agent of its functions. This would not be in the interests of investors, since most AIFM are likely to be less well-capitalised than independent valuation agents and in the event of a failure by a valuation agent to perform its obligations, investors would have no direct claim against the valuation agent. This suggestion also runs contrary to the recommendations of IOSCO, AIMA and the Hedge Funds Standards Board. Further, it introduces a conflict of interest, which is not in the interest of investors, in that an AIFM's fees are calculated by reference to the value of the assets of the AIF which it manages.

#### EU Sub-Advisors

- 4.9 Depending on how the issue of who is the AIFM is resolved, if a non-EU AIFM (for example, a US manager) appoints an EU AIFM (for example, its UK subsidiary) to manage part of the portfolio of an AIF and that EU AIFM also wishes to market shares in the AIF to professional investors in the EU, the AIF's custody, valuation and administration arrangements will need to be modified to comply with the requirements of the Directive, causing significant costs to be borne by the AIF and thus by all of the investors therein.

#### Annual Report

- 4.10 The Directive requires that an AIFM must, for each AIF that it manages, make available to investors and to the regulatory authorities in its own EU member state an annual report for each financial year no later than four months following the end of the financial year. It seems that this report is to be in addition to the report which AIF themselves are required to make available under the law of their domicile (this obligation generally applies irrespective of whether the AIF is established in an EU member state or outside the EU). This will result in additional costs to investors without any obvious commensurate investor protection benefits.

## 5. Conclusion

- 5.1 It seems certain that the Directive in its current form will restrict the ability of EU investors to select the AIFM and AIF of their choice, will result in substantially increased initial and ongoing compliance costs and one-off restructuring costs which, ultimately, will be borne by investors, will impose barriers to entry for start-up managers, will reduce competition amongst the providers of depositary services and will effectively lead to a diminution of the responsibilities of independent boards of directors of AIF.

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