



# Summary of the European Commission's draft directive for Alternative Investment Fund Managers (AIFMs)

24 July 2009



International Centre for  
Financial Regulation

# The Directive

On 30 April 2009, the European Commission submitted its proposal for a directive on Alternative Investment Fund Managers (the “Directive”) to the European Parliament and to the European Council.

The Directive provides a regulatory framework for managers of hedge funds, private equity firms and other alternative investment vehicles.

The Directive offers potential advantages for some; pitfalls for others.

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# Background and Rationale

*The key drivers:*

- Enormous pressure on the European Commission in relation to the activities of hedge funds and private equity funds.
- Considering the ongoing financial crisis, some political and regulatory bodies have taken a more hostile approach to the offshore financial centres.
- Lack of harmonisation across the EU in relation to the requirements for managing and marketing of unregulated funds.
- Professional investors exposed to Madoff through funds marketed in the EU. Therefore rules on depositary arrangements to be tightened.
- Heavy selling of investments by many funds during the credit crunch may have exacerbated volatility and thereby had an impact on the markets.

# Background and Rationale (cont...)

*The legislative and policy drivers:*

- September 2008: Poul Nyrup Rasmussen (Leader of the party of European Socialists) report on hedge funds and private equity funds and Klaus-Heine Lehne (European People's Party) report on transparency of institutional investors.
- November 2008 G20 Leaders' pledge: *"to strengthen our regulatory regimes, prudential oversight and risk management and to ensure that all financial markets, products and participants are regulated or subject to oversight as appropriate in the circumstances"*.
- February 2009: the de Larosiere report discussed closing regulatory gaps in the *"parallel banking system"* which included hedge funds, investments banks and other funds and the European Commissioner for the Internal Markets and Services (Charlie McCreevy) proposals for the regulation of hedge funds.
- March 2009: Commission's "Driving European Recovery" Communication stated that the Commission would propose *"a comprehensive legislative instrument establishing regulatory and supervisory standards for hedge funds, private equity and other systemically important market players"*.

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# Guiding Principles

- The Directive is an attempt to create a coordinated approach for the regulation and supervision of the alternative investment fund management industry.
- Essential requirement to ease the pressure for further regulation on AIFM's activities on a pan-European basis.
- The Directive seeks to regulate all the major sources of risks in the alternative investment value chain.
- The key principles of the Directive focus on what the Commission believes to be the sources of systemic and operational risk, enhanced investor protection and regulatory disclosure.

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# The Objectives

- Creating a comprehensive and effective regulatory and supervisory framework for AIFMs in the European Union.
- Organising a regulatory regime for investment products that are mainly structured for professional investors.
- Enhancing the sharing of information between member states and monitoring of macro-prudential risks at the national and European level.
- Enhancing investor protection via enhanced transparency and operational requirements.
- Ensuring that service providers as well as funds can act and be marketed throughout Europe.
- Ensuring appropriate treatment of “third countries” entities.

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# The Scope

- Introduces a legally binding authorisation and supervisory regime for all AIFMs managing AIFs in the EU.
- All EU-based AIFMs currently not authorised by the UCITS regime are covered in the Directive's scope hence it has very broad application.
- The Directive will not apply to AIFM managing alternative investment funds (AIF) portfolios with total assets of less than €100 million or €500 million when such AIFs are not leveraged and have no redemption right lock-in periods of 5 years from constitution.
- Common set of rules for AIFMs using leverage or taking controlling stakes in companies.
- Non-EU based AIFMs permitted to opt into the regime after a waiting period of three years.

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# The Key Features

- All AIFMs will be required to be authorised with their EU “home member state” regulator to provide management services to AIFs.
- Detailed information about each AIF will have to be submitted by the AIFM to its home member state regulator upon authorisation and on an on-going basis.
- AIFMs will be subject to minimum regulatory capital and ongoing regulatory requirements.
- AIFMs must have own funds of at least €125,000. Where the value of the AIF portfolios managed by an AIFM exceeds €250 million, an AIFM needs additional own funds equal to 0.02% of the exceeded amount.
- AIFMs must appoint:
  - an independent “valuator” to value assets and shares/units at least annually;
  - an independent EU incorporated credit institution to act as depositary; and
  - EU qualifying auditors.
- AIFMs must separate the functions of risk management and portfolio management, and implement systems to measure and monitor all risks associated with each AIF investment strategy.

# The Key Features (cont...)

- The Directive requires AIFMs to provide their investors with a clear description of their investment policy.
- AIFMs must disclose to regulators and investors the maximum level of leverage that will usually be employed and, on a regular basis, must disclose the total amount of leverage actually employed.
- The Directive grants additional emergency powers to the national authorities to restrict the use of leverage in respect of individual AIFMs.
- The Directive allows AIFMs from 2014 onwards to market in the EU AIFs domiciled in a "third country".
- The ability of AIFMs to delegate service provision outside EU is limited.
- The Directive allows an authorised AIFM to market its funds to professional investors in its and any other home member state.

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# The Reactions

- The Directive has received a mixed reception. Many commentators in the UK oppose the Directive. By contrast, Christine Lagarde (French Finance Minister) and Poul Nyrup Rasmussen (Leader of the Party of European Socialists) state that the Directive does not go far enough to regulate the AIF industry.
- Some private equity firms fear that overly stringent compliance requirements would penalise venture and mid-market funds.
- Some members of the hedge fund industry have stated that the EU passport requirement for “third country” AIF is too far reaching and unclear.
- Others have flagged that the Directive has failed to address taxation and to limit investment strategies such as short-selling.

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# Key Quotes

- *“Perhaps out of necessity, it was produced under extraordinary time pressure. This has yielded a directive whose scope and content are a surprise and in many cases a complete shock to the markets that are affected”* Dan Waters, Asset Management, FSA.
- *“It looks as though the directive was drafted for hedge funds and private equity was shoved in at the last minute”* Private Equity Houses.
- *“The EU proposal contains good ideas, but it doesn't go far enough”* Peer Steinbrueck, German Finance Minister.
- *“If you are concerned with what might potentially affect the economic and monetary system, you obviously don't want to deal with businesses that are below the parapet”* John Purvis, Conservative British MEP.
- *“Running an international asset management business from Europe is made very difficult if not impossible imposing European rules to the whole value chain”* Jarkko Syyrilä, Investment Management Association.

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# Next Steps

- The Directive is progressing through the EU's "co-decision" procedure. If political approval is obtained by the end of 2009, the Commission envisages the Directive to come in force in 2011 although this could easily slip until 2012.
- The Directive is intended to be implemented in member states through domestic legislation.
- Regulation of and for the AIFM industry is inevitable – UK has no veto/block.
- Amendments of the Directive are needed – as current draft's shortcomings have been widely debated and acknowledged.

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