

Razor Alert

Isaac Lustgarten
Occam Regulatory Solutions LLC
225 East 57th Street, Suite 2F
New York, New York 10022
917 209 8709
ilustgarten@occamregolutions.com



EU proposed Directive on Alternative Investment Fund - what really matters and how it differs from US proposals

Summary

The European Commission has issued a proposed Directive to regulate AIFM (alternative investment fund managers). AIFMs are the managers of alternative investment funds (AIF). An AIF is essentially a collective investment product that is not a UCIT. The proposed Directive provides for various registration, reporting, and risk management requirements which may impose operating costs on AIFMs. More importantly, from the AIFMs' perspective, certain provisions of the proposed Directive would affect the actual business practices of AIFMs and their investment strategies. For example, the proposed Directive regulates derivative investments owned by AIFs and allows supervisory authorities to collect and share information and intervene for the orderly functioning of markets. The proposed Directive also restricts the securitization investments of AIFs, would require Member States to impose leverage and risk management requirements, would require an AIFM to report positions in certain securities, would impose capital requirements on the AIFM, and would require reporting of controlling and other positions in listed and non listed companies.

Scope

The proposed Directive requires that an AIFM that manages over 100 million Euros to register and comply with the new regulatory framework. An exemption from regulation exists for an AIFM that manages 500 million Euros or less, has no leverage and does not allow investment redemptions for five years.

The proposed Directive applies to AIFMs that manage AIFS marketed in the EU or when the AIFM operates in the EU, but not when the AIF invests in EU assets and has no EU operations or investors. As a result, there is a gap in the information the regulators would obtain about EU investment assets. The proposed Directive explicitly excludes from its coverage mutual funds, pension funds, sovereign wealth funds, banks and insurance companies covered by other directives.

The proposed Directive is much stricter than and differs from 2 separate US legislative proposals to regulate AIFMs and AIFs. One US proposal to regulate managers requires registration of managers and requires managers to submit some information about their operations, conflicts, experience, etc. to the SEC. Another US proposal to regulate funds would require the funds to register in the same way as mutual funds and provide similar information to investors and the SEC. Neither US proposal imposes the kinds of restrictions on investment strategy, derivative investments, asset securitization investments, and short positions that the EU proposal imposes. Currently, the US imposes indirectly restrictions on AIFs by requiring their broker dealer and bank counterparties to conduct due diligence on AIFS with which they do business and observe best practices.

Information Sharing among Supervisory Authorities

The proposed Directive would regulate the content and frequency of exchange of information regarding AIFMs between the competent authorities of the home Member State of the AIFM and other competent authorities where the AIFM individually or collectively with other AIFMs may have an impact on the stability of systemically relevant financial institutions and the orderly functioning of markets.

Derivatives Investments of AIFs and Power of Supervisory Authorities to Intervene for Orderly Functioning of the Markets

The proposed Directive allows the supervisory authorities of Member Countries to take action for macro prudential purposes where it would be necessary to protect the orderly functioning of some financial markets, especially in those cases where an AIF does not have a material interest in the underlying product or instrument from which those markets derive and therefore the efficient functioning of those markets is hindered. (Possibly, this

power to intervene would apply to certain short sales, naked credit default swaps, securities lending and other derivative transactions.) The supervisory authorities would enjoy the powers necessary to monitor the activities of AIFM in those markets and to intervene in those circumstances where it would be necessary to protect their orderly functioning. The action to be taken is not articulated.

Some US legislative proposals would bar the use of naked credit default swaps where the investor does not have an interest in the underlying instrument or other interest in the reference entity. Other US legislative proposals would subject all swaps (exchange traded and over the counter swaps) to regulatory supervision. Some US state insurance regulators have sought to restrict the credit default swaps activities of insurance companies where there is no underlying instrument. None of these US initiatives is limited to managers or funds; all of them would apply more broadly.

Securitization Investments of AIFs

With respect to asset securitization investments, AIFMs would be required to

- invest only in such investments where the originator retains 5% of the risk.
- comply with certain conditions when investing in such securitization instruments.

There is a recent BIS proposal to require banks to retain 5% of the risk of assets they securitize. One US congressional committee is considering imposing a similar retention of risk requirement on asset securitization originators.

Leverage, Short Sales, Liquidity and Risk Management Requirements

AIFMs would be subject to

- risk management requirements (via stress tests) and specific reporting requirements particularly with respect to categories of risks, illiquid assets, liquidity arrangements, use of short selling, and redemption rights.
- requirements that a highly leveraged AIF (where the combined leverage from all sources exceeds the value of the equity capital of the AIF in two of the past four quarters) disclose leverage, the reuse of collateral and any guarantees that are given (including borrowing of cash or securities or leverage embodied in derivatives).
- disclosure requirements regarding leverage and the frequency of reporting to competent authorities and to investors.
- liquidity management requirements.

- limits on the level of leverage an AIFM may employ when managing AIF and require related disclosure requirements.

Reporting Positions in Securities

Member states would be required to adopt regulations to determine the detailed content and the way an AIFM acquiring a controlling influence in issuers and non-listed companies should fulfill information obligations towards such companies and employees, including the information to be provided in the annual reports.

Member countries must require an AIFM which in aggregate acquires 30% of the voting rights or 30% of the capital of “large” listed and nonlisted companies to disclose to shareholders such information. For nonlisted companies, disclosures resembling those of the Takeover Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 must be made. There are no specifics regarding interests which arise from derivatives. This proposed requirement is similar to the large trader reporting requirements imposed by the US CFTC, although for different purposes. US Congress and various US financial regulators are considering similar reporting requirements for funds.

Capital Requirements

AIFMs would be required to maintain minimum own funds of (1)125,000 Euros plus (2).02% of excess over 250 million Euros. Such own funds must never be less than required under Article 21 of the Directive 2006/49/EC of the European Parliament and the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions. This amount currently would equal 25% of the previous year’s fixed costs.

Miscellaneous Operational Provisions

The proposal is intended

- to allow an AIFM not covered by the Directive to be treated as an AIFM covered by the Directive.
- to require an AIFM to identify, prevent, manage and disclose conflicts of interest.
- to require independent asset valuers.
- to determine the permissibility of an AIFM’s delegating functions to certain delegates.

- to specify the content and format of the annual report for investors and more frequent reports for supervisors that AIFMs have to make available for each AIF they manage.
- to condition the marketing of AIF to professional investor.
- to assess equivalence of valuation, custodial and depositary standards of third countries where the valuator, custodian or depositary is established in a third country, and require the ongoing supervision of such valuator, custodian and depositary.
- to specify general criteria for assessing whether third countries grant Member States' AIFMs effective market access comparable to that granted by the Community to AIFM from third countries.
- to specify the procedures for on the spot verifications and investigations.