

# Hedge Funds

How will the proposed EC Directive on Alternative Investment Fund Managers impact hedge funds?

July 2009



## Key points:

- Aims to provide additional protection to investors
- But significant increased costs for investors
- Restructuring of custody, administration and valuation arrangements
- New responsibilities for service providers
- Consider feasibility of launching EU-domiciled “mirror” funds
- Regulators can control leverage levels
- Raise concerns via trade body and local regulator initiatives

## Background and scope of Directive

The potential impact of the EC's Directive on Alternative Investment Fund Managers ("AIFMs") on the hedge fund industry – not just in the EU, but globally - must not be underestimated. Although politicians and regulators in the EU and the USA have acknowledged that hedge funds and other Alternative Investment Funds ("AIFs") were neither the cause of the crisis nor played a significant role in it, the European Commission has effectively pre-empted work being undertaken by the Financial Stability Board, IOSCO and the G20 by proposing draft legislation which, if enacted in its current form, will impose a disproportionate regulatory regime on the managers of all collective investment vehicles which are not authorised UCITS, whether open or closed ended and whether or not listed, subject to a few minor exclusions.

The background to, and scope of, the EU's proposed Directive is set out in the June 2009 edition of PricewaterhouseCoopers' Asset Management News – see Appendix.

## Core requirements of the Directive

All AIFMs (such as hedge fund managers) which are caught by the Directive will need to be regulated by their "home state" financial regulator. The authorisation process will require submission of detailed information to the regulator about managers and controllers, about the AIFs to be managed (strategies and constitution), the countries where the AIFs are to be sold and details of the custodians, valuers and other third parties to whom material functions are delegated.

All AIFMs which become regulated will be responsible for both managing and administering their AIFs, and will need to have:

- Documented internal systems of management and control complying with EU standards (as yet unspecified) relating to liquidity, management of conflicts of interest, risk management (including appropriate "documented and regularly updated due diligence when investing") and short selling;
- Regulatory capital of not less than €125,000, with additional own funds equal to 0.02% of the amount by which portfolios under management exceed €250m;
- An independent "valuator", who must value assets in the AIF every time a subscription or redemption takes place, and at least annually, in accordance with "existing applicable valuation standards and rules" (presumably local GAAP) or in accordance with rules set out in the AIF's constitution;
- An independent depositary (which must be an EU authorised credit institution), whose function will be to receive investor subscriptions, safe keep financial assets and to verify the AIF has ownership of assets it has invested in.

An AIFM's ability to permit its valuator or depositary to delegate functions to non-EU valuers or banks, to appoint non-EU valuers or custodians or itself to delegate functions (including investment management) to third parties (particularly non-EU entities) will be severely limited and subject to detailed procedural requirements. Where an AIFM delegates some of its functions to a third party, that third party will not be permitted to further sub-delegate any of those functions.

All AIFMs will be required to produce an audited annual report for each AIF that it manages, to be made available within 4 months of the AIF's financial period end to investors and the AIFM's regulator. The auditor must be EU empowered.

**Table 1: Issues for service provider arrangements**

Directive requirement	Issue
<b>Depositary/ custodian must be a EU credit institution</b>	Very few prime brokers currently qualify
<b>Non-EU administrators must be regulated, subject to prudential supervision; co-operation agreement must exist between regulators of AIFM and administrator</b>	Many non-EU administrators do not qualify
<b>Valuator must be independent of AIFM, and have no conflicts of interest with AIF or investors</b>	Some administrators may not qualify to act as independent "valuator"
<b>Auditor must be an EU empowered auditor</b>	AIF may require more than one audit if local auditor not EU empowered

All AIFMs will be required to disclose to their regulators details (yet to be specified) of the principal markets and investments in which they trade (including, on an aggregated basis, details of their principal exposures and concentrations) and details of their leverage through quarterly reporting. The Directive contains unusual provisions specifying that the Commission (rather than a home state regulator) can impose caps on the amount of leverage an AIF can employ. The home state regulator of an AIFM can impose additional limits on leverage, in exceptional circumstances, if required to maintain financial system stability.

AIFMs will be required to produce detailed investor information for prospective investors in AIFs and, to the extent they use leverage on a systematic basis, detailed information on that usage on a quarterly basis.

Participations in AIFs managed by AIFMs may be sold only to professional investors (as defined in MiFID). Initially AIFs may be marketed to professional investors in the AIFM's home member state but may, subject to complying with passporting requirements, also be sold to professional investors in other member states.

Although the Directive establishes clear procedures for marketing AIFs domiciled in the EU, the ability of an AIFM to market non-EU domiciled AIFs will be subject to detailed restrictions, including a requirement that the AIF's jurisdiction has signed an agreement to share tax information (which complies fully with the OECD standards) with the jurisdiction into which the AIF is to be marketed. This passport will not be available for three years after commencement of the Directive, and prior thereto, non-EU domiciled AIFs may only be marketed into those EU states where they can be sold under domestic law (as currently).

If non-EU domiciles do not sign up to appropriate information sharing frameworks with EU member states and are not judged "equivalent" to the EU in relation to their depositary arrangements, an EU-based AIFM will not be able to market AIFs domiciled in such non-EU countries in the EU. AIFMs may need to consider the feasibility (e.g in terms of investment restrictions and tax transparency) and costs of setting up EU-domiciled "mirror" versions of existing funds.

## Practical implications for the hedge fund industry – and unanswered questions

### Do investors want these significant additional costs?

The business implications of most of the matters discussed below are that there will be additional costs of compliance, including additional regulatory capital, the costs of providing additional information to investors and regulators, renegotiation and restructuring of service provider arrangements and the costs thereof, and the costs of amending offering memoranda, including obtaining any investor consents.

It is likely that the majority of the additional costs will be charged to the AIFs, and therefore borne by investors. No regulatory impact cost analysis has been provided by the Commission and it is unclear whether the benefits to investors – most of whom are professional investors – in terms of additional protection, will outweigh the incremental costs.

### More regulatory capital?

The Directive will require many AIFMs to hold additional regulatory capital:

- A \$1bn hedge fund manager will need to keep "own funds" regulatory capital of €218,000/ £190,000 (see table 2). If a \$1bn manager has fixed expenses of less than £760,000, its total regulatory capital requirement under the Directive will exceed its existing capital requirement under MiFID.
- The "own funds" requirement increases by €145,000/ £125,000 for every additional \$1bn of assets under management (being equivalent of 0.02% of \$1bn).

**Table 2: Regulatory Capital Requirement**

<b>AUM</b>	= \$1bn
<b>Own funds requirement</b>	
<b>Base level</b>	= €125,000
<b>0.02% of €465m</b>	
<b>(€15m - €250m)</b>	= €93,000
	€218,000
<b>Sterling equivalent</b>	£190,000
<b>Equivalent to MiFID requirement of 13/52 x £760,000</b>	



### **The independent Board is largely ignored**

Many hedge funds, for governance, tax and other reasons, have an independent Board of Directors, which exercises the central management and control of the fund and oversight of the various service providers, including the AIFM, administrator, prime broker/ custodian and valuation agent (if any). Although the Directive applies to AIFMs rather than to AIFs directly, it imposes many obligations on AIFMs to ensure that the AIFs they manage comply with certain criteria, and indirectly, therefore, it imposes many onerous requirements on AIFs managed by AIFMs in the EU.

The Directive states that management services include administering AIFs as well as managing them, and although AIFMs may delegate administering to third parties, the AIFM is responsible for the services provided by each third party and for their ongoing review. This means the AIFM is responsible for the actions of the administrator, in contrast to most existing hedge fund arrangements where the administrator is accountable to the Board of Directors of the fund, not the AIFM.

There is the potential for conflict between the wishes of the Board and the requirements imposed on the AIFM by the Directive; what are the implications for the independence of the Board? For example, the AIF's Board may wish to appoint (or retain) a non-EU fund administrator because it is considered the best qualified for the job, yet the Directive might dictate that the AIFM cannot appoint (or retain) that particular administrator.

### **Does this create additional tax risk?**

In general, the Directive transfers many of the responsibilities from an AIF's independent Board to the AIFM, and will require the industry to critically assess the contracting arrangements and functions of such Boards. There is a (tax) risk that, if the Board has very little left to do, it will be more difficult to demonstrate that an AIF is not tax resident in the domicile where the AIFM is located. Even greater clarity will be required in demonstrating strict independence of the AIFM from the fund; for example, the constitution of a AIF may need to specifically provide for the removal of the AIFM by the Board, and it may become unacceptable for a member of the AIFM to sit on the Board or for parties connected with the AIFM to hold founder/ management shares in the AIF conferring exclusive voting rights.

### **Tighter accounts preparation timetable and more costly year end reporting process**

The rules surrounding provisions of audited annual reports give rise to various practical issues:

- The 4 month deadline from the financial period end may represent a significant acceleration in existing requirements, for example for Cayman-domiciled funds where CIMA imposes a 6 month filing deadline. Given the popularity of 31 December financial year ends, fund administrators, as well as an AIFMs' internal operations teams and fund auditors, will be under additional resourcing pressure between January and April to meet the accelerated timetable. Service providers may charge a premium for annual reports prepared during this critical period. AIFMs may wish to build additional service standards into fund administration contracts, or even consider changing an AIF's financial period end.
- The requirement for the AIF's annual report to be audited by an EU empowered auditor means that, where a local audit "sign off" requirement is required by local regulation or law (e.g. in Cayman), a non-EU domiciled AIF may find that it needs an audit sign-off by more than one auditor. Additional costs will arise from this second audit.

## Costs of reporting information to investors/ regulators

The Directive contains a significant number of requirements for reporting of information to investors, both before they invest and on an ongoing basis, as well as to regulators. Significant rewriting of offering memoranda will be required, as well as systems enhancements to allow the capture of the required information on an ongoing basis. Both these requirements will incur additional costs.

The requirement for the appointment of various service providers to the AIF to be approved by the AIFM's home regulator will require regulators, in particular the UK's FSA, to increase resource levels. The additional costs will likely result in increases to FSA fees, such as those that have recently been seen in the banking industry.

## Liquidity management system

The Directive's requirement to put in place an appropriate liquidity management system for each AIF, with appropriate stress testing, will lead to additional costs in relation to modelling the various scenarios. There is no guidance as to who will oversee the appropriateness of such systems. AIFs may also need to obtain investor consent to change their constitutions and rules to allow flexibility in redemption and other changes in liquidity profile.

## Will you need to change your custody arrangements?

The Directive requires the depositary used by an AIF to be a credit institution that is based, authorised and supervised in the EU. The Directive also restricts the extent to which depositaries may delegate their rights and obligations, particularly when outsourcing to depositaries outside the EU. If losses are caused by delegates (sub-depositaries), depositaries will effectively be held liable to AIFMs and investors in AIFs for such losses, regardless of whether they delegated their tasks on a reasonable basis in terms of due diligence and selection. Many depositaries feel aggrieved at the prospect of being held accountable for such losses which they consider are outside of their control. Traditionally they operate business models with fee structures that do not allow for this additional risk. Consequently, depositaries may become more selective as to which AIFs they wish to service and may need to increase fees. It seems that higher insurance costs will also be inevitable.

It is currently believed that only a small number of prime brokers are EU credit institutions and many sub-custodians outside the EU will not possess this status. Will existing prime brokers be willing to undertake the substantial expense of becoming EU credit institutions?



This change to the infrastructure of the industry will impact on the business models of the existing participants. It is to be expected that the result will be renegotiation of existing prime brokerage and custody arrangements. It is possible that some EU credit institutions may not always be the most appropriate specialists for the job (for example, in certain emerging markets), which will carry attendant risks to investors. The costs of finding a new depositary, of negotiating the new depositary contract, and of the transition itself, will need to be funded – again presumably by investors in each AIF.

## Does AIFM take on liability for administration of an AIF?

The Directive states that administration is a function of the AIFM and that although this function may be delegated to a third party, the AIFM remains responsible for this function and for due diligence over the administrator on an ongoing basis. This puts liability onto the AIFM for errors by the administrator that are currently considered as an oversight responsibility of the Board – if the AIFM is required to accept this additional risk, there will be additional costs.

### Can the administrator also be the independent valuator?

The Directive requires a “valuator”, independent of the AIFM, to be appointed and contains a general requirement for all conflicts of interest between the AIF, the AIF’s investors and the AIFM, to be identified and managed. Presumably, in many cases the AIF’s existing administrator would be the logical choice to take on the role of the “valuator”.

However, AIFMs will need to consider whether the administrator is truly independent and therefore can act as the independent “valuator”. In this context what does “independent” mean? In particular:

- Where the administrator is owned by a banking institution (as in many cases), does this preclude the bank from acting as the prime broker or depository of the AIF, or from having capital invested in the AIFM or in the AIF?
- Where the basis of calculating the administration fee is as a % based on the value of the AIF’s portfolio as determined/valued by the administrator, this would likely be considered to be a conflict between administrator and the AIF. This may mean that administrators who also perform the role of the independent valuator will need to change their fee charging structures. Alternatively, a valuator who is independent of the administrator could be appointed – but again there would be additional costs.
- It may also be seen as a conflict for employees of the administrator (or, indeed of the AIFM, such as the portfolio manager) to sit on the board of the AIF.
- Where an indemnity agreement is in place by the AIF to the administrator, what is the impact of this on independence?

### Qualifications and costs of the valuator

AIFMs will need to consider the ability of existing third party administrators to independently value hard-to-value positions, as any involvement by the AIFM in the valuation process – e.g. in the sourcing of inputs to models – would appear to conflict with the independence concept. There will be significant demand for sources of expertise for such valuations and the cost of such services - which may need to be performed as often as weekly depending on the AIF’s liquidity profile, and which will also take into account that the valuator will need to accept liability for valuations – are likely to be significant. Who will pay for these costs? Will administrators wish to accept a higher level of potential liability associated with performing the valuator role, without additional compensation?



### You may need to change your administrator

Where it is concluded that the administrator of the AIF is not acceptable under the Directive (which may be the case for a number of reasons, for example if they are located outside the EU and are not subject to prudential supervision), who will pay for the costs of finding a new administrator, the costs of negotiating the new administration contract and costs of the transition?

### A mandatory reduction in leverage

The requirements of the Directive in relation to leverage include a number of practical issues with measurement, for example:

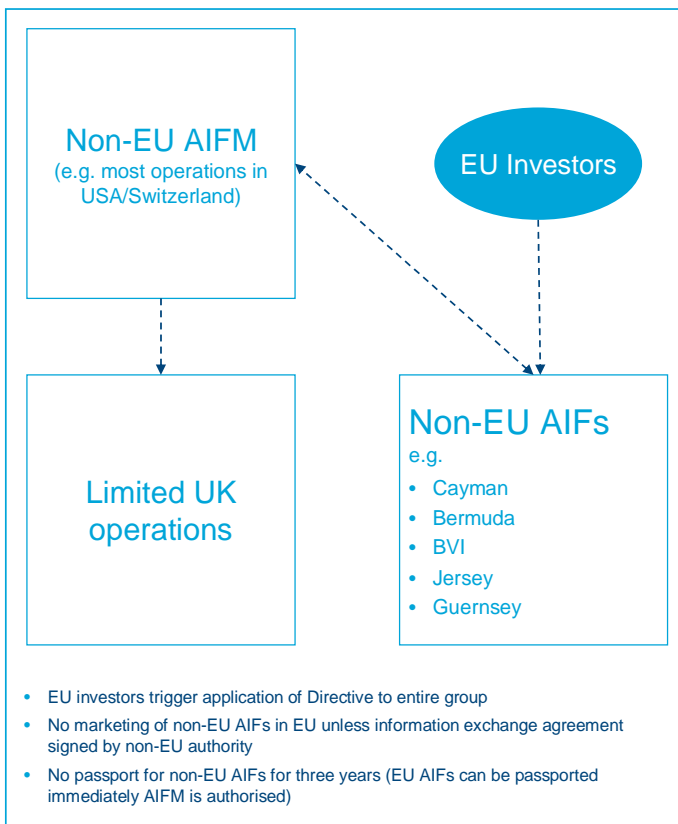
- Does the AIFM need to assess the leverage across all the AIFs it manages, or only on a fund-by-fund basis?
- How is equity capital defined? Many open-ended funds have very little equity capital because, under GAAP rules, investors’ capital is classified as debt as it is redeemable.
- Does the leverage have to exceed assets for the whole of two out of the last four quarters, or merely for one day within each of two quarters?

The Directive also allows the home state regulator to set leverage limits and in exceptional circumstances to impose additional temporary limits, thus potentially interfering with investment strategies and conflicting with the contractual relationships between AIFs and their investors.

## Overseas AIFM groups with limited operations in the EU

The draft Directive contains an exemption for AIFMs based in the EU which only provide management services to non-EU domiciled AIFs, as long as the particular AIFM does not market any AIFs in the EU. However, if such a AIFM (which could be a UK sub-adviser to, for example, an offshore lead investment manager or to a large US hedge fund manager – see Chart below) does market its funds to EU investors, it is likely that it would have to comply with the requirements of the Directive in respect of its entire structure and operations outside of the EU. This could have a significant impact on, for example, AIFMs in the US with subsidiaries in the UK; to retain their EU investors, they may need to change their administration, custody and valuation arrangements, causing significant costs to be charged to the AIFs and therefore borne by all investors globally.

### Third Country Groups



## Conclusion

Given the proposed reach of the Directive, it is crucial that AIFMs (hedge fund managers) assess the potential impact of the Directive on their operations immediately, so that they can start evaluating and planning for the changes the Directive will require. Managers should be estimating the likely costs that will be involved both in the restructuring of operations and service provider arrangements and in the ongoing compliance responsibilities.

The indicative time for consultation on the Directive and its implementing regulations is short, so industry participants with significant concerns about the Directive need to act now – via industry body and local regulator initiatives - to ensure their views are heard. If political approval on the Commission's proposals is reached by the end of 2009, the Directive could come into force in 2011.

We are working actively with hedge fund managers, as well as regulators and industry bodies, to assist them in assessing the impact of these proposed changes on individual businesses and the industry generally.

## Who to contact

If you have any questions on any of the above matters, please speak to your usual contact at PricewaterhouseCoopers or alternatively any of the following individuals:

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See overleaf for extract from the June 2009 edition of PricewaterhouseCoopers' Asset Management News.

# Europe's Alternative Investment Fund Managers Directive poses more questions than it provides answers

If the EU enacts the Directive in its current form, it may impose a disproportionate regulatory regime on managers of alternatives funds that are not authorised UCITS.



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On 1 May, 2009, the European Union published its draft directive on Alternative Investment Fund Managers ("AIFM"), (the "Directive"). The Directive, as drafted, will radically reshape the alternative asset management industry in the EU, potentially requiring changes to AIFMs' business models and significantly increasing the regulatory demands on AIFMs, including increased capital, disclosure, risk management and liquidity measures, reporting and other costs. The Directive also poses a number of questions about the accessibility of the EU's markets to non-EU alternative fund managers and funds and how EU-based managers with funds or connections outside the EU are going to be able to continue to operate. In addition, the Directive has important implications for administrators, valuers, depositories, prime brokers and custodians and other service providers to AIF.

The AIFM is the EU's response to comments in the G20 Communiqué, which referred to the need for certain systemically important hedge funds to be regulated, and for financial regulators to have access to information necessary for the assessment of systemic risks and the tools necessary for effective macro-economic oversight. Macro-prudential risks associated with the use of leverage primarily relate to the activities of hedge funds, however, the Directive goes further, proposing the creation of a comprehensive regulatory environment for all alternative investment fund managers, including those managing private equity, commodity, real estate and infrastructure funds. The Directive not only addresses systemic risk but also, with a key focus on micro-prudential issues and risks associated with inadequate governance arrangements, has a key objective of ensuring a high level of consumer and investor protection. This will be achieved by specifying a detailed common framework for the authorisation and supervision of AIFM.

It could well be argued that this level of consumer protection goes beyond what is actually required by the Professional/Qualified investors, who will be the only categories of investor to whom participations in AIFs will be able to be sold. It may also prove expensive not only for the AIFM, who may well have to adopt costly policies and procedures to satisfy the Directive's requirements, but also indirectly for those investors to whom it is likely AIFMs will seek to transfer those costs by recharging the AIF.

## Applying to a wide range of alternatives managers

The Directive affects the managers of hedge funds, private equity funds, real estate funds and infrastructure funds, as well as REITs, listed investment trusts and many other forms of collective investment vehicle which have previously been outside the scope of financial services regulation. AIFM that are divisions of EU banks or insurers, or are authorised pension fund managers and various categories of sovereign wealth funds, however, are excluded from the scope of the Directive, putting those institutions at a relative competitive advantage.

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Fund managers established outside the EU will be able to seek authorisation from a member state in order to market shares or units in any AIF in the EU, subject both to themselves and the jurisdictions in which they are based meeting certain stringent conditions.

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The Directive, as drafted, will apply to all AIFM with assets under management in excess of €100m, irrespective of the number of AIF managed or the nature of those assets. It is unclear if this is net or gross assets but the definition does include assets “acquired through the use of leverage”. AIF with assets up to €500m under management that do not use leverage and prohibit investor redemptions for five years from subscription are excluded (which may provide a significant competitive advantage to Shariah compliant AIF and other unleveraged AIF). The Directive is deliberately not sector specific. For example, as the thresholds are arrived at by the aggregation of all funds under management (rather than on a per fund basis), real estate funds which are managed professionally are likely to come within its scope, although the systemic risk of such funds is questionable.

Fund managers established outside the EU will be able to seek authorisation from a member state in order to market shares or units in any AIF in the EU, subject both to themselves and the jurisdictions in which they are based meeting certain stringent conditions. These include determinations by the EU Commission as to equivalence of the law and regulatory supervision in non-EU member countries with laws and supervision in the EU, and the existence of effective information sharing agreements on tax matters in accordance with the standards laid down in Article 26 of the OECD Model Tax Convention.

### A disproportionate regulatory regime?

The Directive has the potential to be beneficial. There will be merits to a uniform platform of regulation and, certainly, a passport for funds and their managers in the AIF industry will be an advantage. However, if enacted in its current form, the Directive risks imposing a disproportionate regulatory regime on the managers of all collective investment vehicles which are non-qualifying UCITs and which are intended only to be available to sophisticated investors, as well as seeking to achieve tax-related objectives which are inappropriate for a Directive intended to provide a framework for regulating managers. It also leaves the position of established funds that are already fully invested unclear.

The time for consultation on the Directive is likely to be very short. The draft will now be sent to the European Parliament and European Council, where the Commission expects it to be the object of intense political discussion and negotiation. If political approval on the Commission’s proposals is reached by the end of 2009, the Directive could come into force in 2011.

It is crucial that industry participants assess the potential impact of the proposed Directive immediately and act now, so that they can seek to influence the shape of the final Directive and its implementing regulations, and, to the extent necessary, start planning for the changes the Directive will require.

This publication has been prepared by hedge fund specialists across the PricewaterhouseCoopers network, who are a part of our global Asset Management industry group. Hedge funds is one of four distinctive sub-sectors, each with its own opportunities and challenges.

The global Asset Management sub-sectors are:

- Hedge funds
- Private equity
- Real estate
- Traditional investment management

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