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The AIFM-Directive in the context of national regulation

Compliance in the Wake of the AIFM-Directive

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1 October 2009

Agenda

1. Scope of the AIFM-Directive
2. Proposed regulatory objectives and tools of the AIFM Directive
3. Current status of regulation in Germany
4. Which core elements can be expected to prevail?

1. Scope of the AIFM-Directive I

What are *common sense* alternative investment funds?

- aima glossary: “The terms *alternative investment*, *hedge fund* and *absolute return* often get used interchangeably.”
- evca glossary: “Investments covering amongst others private equity and venture capital, hedge funds, real estate, infrastructure, commodities or CDOs.”
- More broadly: Investments outside traditional stock and securities markets.

1. Scope of the AIFM-Directive II

What is the definition of the AIFM-Directive's scope?

- Management or marketing of collective investment undertakings (EU Council: "Include risk-spreading")
- "Non UCITS" (EU Council: "Exclude closed ended funds?")
- Not more than 100 million Euro assets under management (AUM) (EU Council: "Define calculation of threshold where AUM are volatile.")

or

- Not more than 500 million Euro assets under management if AIF not leveraged and lock-in-period of at least 5 years

2. Proposed regulatory objectives and tools of the AIFM-Directive I

In the preface of the proposed directive there have been discussions on how to tackle systemic risks in the hedge fund and private equity market place. Such risks were deemed to be involved in

- leverage and
- short sale.

Two choices had to be made:

1. Regulate an industry or certain investment policies.
2. Regulate the managers or the funds.

2. Proposed regulatory objectives and tools of the AIFM-Directive II

The AIFM-Directive takes a comprehensive approach to both questions:

- It regulates the whole fund industry with all asset classes (except UCITS).
- It addresses “leverage” and “controlling influence” in non-listed companies (systemic risks) specifically.
- It regulates both the manager and the fund.
 - ➔ And it regulates distribution, as well.
- It also introduces investor protection as an objective.

2. Proposed regulatory objectives and tools of the AIFM-Directive III

Fund	<ul style="list-style-type: none">- Requirement for notification of fund (Art. 31)- Requirements for investments in securitization positions (Art. 13)- Depositary (Art. 17) (EU Council: “Not workable”)- Independent valuator (Art. 16) (EU Council: “Not independent”)- Annual reports (Art. 19), reporting obligations to authorities (Art. 27)
Manager	<ul style="list-style-type: none">- Requirement for authorization (Art. 4)- Initial capital of at least EUR 125,000 with further requirements depending on AUM (Art. 14)- Qualification: honest, with due skill, fair and with care and diligence (Art. 9)- Identification, disclosure and management of conflicts of interest (Art. 10)- Risk management (in particular: short sales) (Art. 11)- Liquidity management (Art. 12)
Distribution	<ul style="list-style-type: none">- Requirement for authorization (Art. 4)- To professional investors only (Art. 31)- Disclosure to investors prior to investment (Art. 20)

2. Proposed regulatory objectives and tools of the AIFM-Directive IV

Special obligations for AIF employing high levels of leverage (HLL) (Art. 22 et seq.) (EU Council: “Delete Art. 22.”)

- HLL: combined leverage from all sources exceeds the value of the equity in two out of the past four quarters. (EU Council: “At fund level”)
- Disclosure to investors of maximum level
- Quarterly disclosure of employed leverage to investors
- Regular disclosure to authorities
- Member States and Commission may limit leverage

2. Proposed regulatory objectives and tools of the AIFM-Directive V

Special obligations when acquiring a controlling influence in non-listed companies – not small or medium size enterprise (thresholds: 250 employees, turnover € 50 million, € 43 million balance sheet) - (Art. 26 et seq.) (EU Council: “Delete Art. 26 et seq.”)

- Controlling influence: 30% or more of voting rights
- The AIFM must make information from a substantial list of items available to the company, its shareholders and employee representatives, including
 - the development plan for the company
 - the policy for preventing and managing conflicts of interest, in particular between the AIFM and the company.

2. Proposed regulatory objectives and tools of the AIFM-Directive VI

Regulation of marketing non-EU AIF and AIFM

	EU	non-EU	AIFM-Directive Requirements
AIF		X	Marketing: - Full compliance of fund domicile with Art. 26 OECD MTC
AIFM	X		
AIF	X		- The legislation of the home country has been recognized by the Commission to be equivalent to the AIFM-Directive and effectively enforced. - Reciprocity in terms of market access
AIFM		X	- Agreement on effective exchange of information - Notification of AIF
AIF		X	- Combination of the requirements above - EU-Council: Purchase of AIF units on own initiative of EU-Investors should not be viewed as marketing.
AIFM		X	

3. Current status of regulation in Germany I

Regulation in Germany hinges on the definition of financial instruments in the German Banking Act (KWG) and the Securities Trading Act (WpHG).

In essence:

Financial instruments include

units in open ended or regulated funds

and

securities.

3. Current status of regulation in Germany II

Fund units constitute financial instruments

Fund	<ul style="list-style-type: none">- For open ended funds under the Investment Act (InvG) definition of eligible assets and diversification requirements, limitation on leverage
Manager	<ul style="list-style-type: none">- Regulated investment company (<i>Kapitalanlagegesellschaft</i>) under InvG
	<ul style="list-style-type: none">- Financial service provider (KWG) “financial brokerage”, “financial advice”, also subject to WpHG (implementing MiFID)
Distribution	<ul style="list-style-type: none">- InvG requires registration of fund- This virtually excludes foreign funds from public distribution in Germany – Note: Here the AIFM-Directive would resolve current market impediments!

3. Current status of regulation in Germany III

Non-financial instruments, e.g. closed ended funds set up as limited partnerships or KGs

Fund	- None
Manager	- Only if fund invests predominantly in financial instruments and individuals are investors (Sec. 1 Subs. 1a No. 11 KWG) - Otherwise no regulation
	- BaFin initiative in June 2009 to extend regulation by qualifying fund interests as financial instruments
Distribution	- Requirement to file a prospectus under the Sales Prospectus Act (<i>VerkaufsprospektG</i>) - Broad exemptions available for private placement

3. Current status of regulation in Germany IV

Regulated market	Semi-regulated market	Virtually unregulated market
<ul style="list-style-type: none"> • UCITS (Undertakings for collective investment in transferable securities) • Other open ended regulated funds under InvG (<i>Publikumssondervermögen</i>) 	<ul style="list-style-type: none"> • <i>Spezialfonds</i> • Foreign funds subject to regulation in Germany due to redemption or regulation 	<ul style="list-style-type: none"> • Public limited partnerships (<i>Publikumsgesellschaften</i>) • Private funds

4. Which core elements can be expected to prevail?

There will be a directive.

Time frame: Publication in Official Journal by September 2010, transposition deadline by March 2012

- Risk management
- Disclosure and management of conflicts of interest
- Transparency

THE END