

# What will the AIFM Directive mean?

The Alternative Investment Fund Managers Directive ("AIFM Directive") has consumed more oxygen than any other EU measure proposed in response to the financial crisis and has consumed the bulk of the energy of both the recent Swedish and current Spanish Presidencies. Most recently it has been the subject of a well publicised telephone call between Gordon Brown and Spanish Prime Minister, Zapatero, leading to the almost unprecedented last minute removal of the Directive from the agenda of a meeting of EU Finance Ministers that was due to agree the measure after months of increasingly heated Council Working Group deliberations.

So, clearly there is much political heat in this debate. However, what will this measure actually mean for the fund management industry once it passes? What are the likely practical effects of this hotly fought measure?

## More UCITS?

The first possible change that could result from the AIFM Directive – and there are already signs that this is happening – is a trend to make greater use of the UCITS model as a way of structuring European based funds.

For the uninitiated a UCITS – short for Undertaking for Collective Investment in Transferable Securities – registered in the EU under the UCITS Directive is subject to a relatively high degree of regulation, which has been harmonised across the EU, but in return can be sold to retail investors across the EU under the passport arrangements established under the UCITS Directive.

A move towards greater use of UCITS is partly due to the fact that they are becoming more flexible and a more usable structure for the industry. UCITS III reforms, allowing much greater use of derivatives by UCITS, was a crucial step.

A further change that is also likely to prove important in accelerating this trend is the UCITS IV Directive, to be implemented by July 2011. UCITS IV will have the effect of streamlining the process of cross-border sales of UCITS funds across the EU whilst also giving UCITS managers a useable passport and facilitating UCITS master / feeder structures and cross-border mergers of UCITS. Consequently, UCITS IV will constitute a further pull factor towards UCITS.

But also, for those securities based strategies which can be placed into a UCITS, we see the AIFM Directive potentially acting as a push factor towards UCITS. After all, if a fund is going to be as extensively regulated as is proposed under the AIFM Directive, why not structure the fund as a UCITS, bringing relatively similar levels of regulation but with the benefit of a tried and tested regulatory structure that has the added advantage of being passportable across the EU and to all investors, including retail? By contrast, the AIFM Directive passport's mechanics are untested and only guaranteed for professional investors. With a UCITS you also get the benefit of a structure and regulatory standard that is increasingly recognised globally – particularly jurisdictions such as Hong Kong and Singapore in Asia – meaning that local licensing and recognition arrangements are streamlined accordingly.

## Key Issues

This paper analyses some of the likely impacts of the AIFM Directive – these are likely to include:

- More use of UCITS structures, at least for funds whose strategies can fit into a UCITS wrapper
- Fund managers are unlikely to be able to avoid the impact of the AIFM Directive altogether if an EU investor base is important – although we do see many seeking to set up structures to avoid the Directive and looking to move at least some operations and personnel outside the EU
- We do not see the rest of the world following the European model of private fund regulation, beyond greater disclosure. But we also do not see other states taking immediate retaliatory action against the EU
- The service provider requirements, particularly for custodians, risk reducing choice and increasing cost for the industry

If you would like to know more about the subjects covered in this publication or our services, please contact:

[Nick O'Neill](#) +44 (0)20 7006 1139

[Edward Gander](#) +44 (0)20 7006 4958

[Mark Shipman](#) +852 2825 8992

[Jeff Berman](#) +1 212 878 3460

[Thomas Pax](#) +1 202 912 5168

To email one of the above, please use [firstname.lastname@cliffordchance.com](mailto:firstname.lastname@cliffordchance.com)

Clifford Chance LLP, 10 Upper Bank Street, London, E14 5JJ, UK  
[www.cliffordchance.com](http://www.cliffordchance.com)

## Nowhere to hide?

But what about all the funds that cannot become UCITS? This is an extensive group including private equity funds, real estate funds and more highly leveraged and alternative investment focused hedge fund strategies. If these funds are managed from an EU jurisdiction, irrespective of where the fund is based, they will be caught by the AIFM Directive. This will mean a wide range of new and relatively onerous regulatory obligations. These include extensive transparency requirements – requiring disclosure to investors, regulators and investee companies in case of private equity - capital requirements based on funds under management, leverage reporting and potentially restrictions and obligations to appoint depositaries and valuers for all private funds (not unusual for hedge funds but not so typical for private equity funds).

The question therefore arises whether private funds and their managers will look to alter their structures so as to avoid the AIFM Directive by locating their activities – particularly their management operations – outside the EU. Considering that 80% of hedge fund management operations within the EU are carried on in the UK and the UK will introduce a top rate of income tax of 50% on UK based personnel from April 2010, there may be more than just regulatory incentives to relocation of management operations reinforcing any incentive to relocate coming from the AIFM Directive.

The Directive will, though, make it difficult to escape its clutches, at least if accessing an EU investor base is important to the relevant fund. In its current draft form, the Directive would apply various of its provisions to funds that are managed outside of the EU. The rules that will apply in those circumstances are the transparency rules requiring disclosure to investors and to regulators. Where a fund is established and managed outside the EU it is envisaged that reports to regulators will need to be made to the regulators of each EU Member State where the fund is marketed – which could become a seriously onerous obligation for non-EU managers seeking to market their funds into a number of EU jurisdictions. This is certainly something which is grabbing the attention of managers in the US and Asia.

In addition, co-operation arrangements relating to systemic risk oversight are required to be in place between the regulators of the state of the manager and each EU Member State into which the funds are being sold before such sales can take place.

The Directive envisages the Commission devising a "common framework" to facilitate those co-operation arrangements with third countries. Consequently, it will hopefully be a relatively standard set of arrangements. However, the fact that this would look to require a state by state regulatory process will in itself represent a significant burden for those seeking to market into the EU and may therefore represent a major hurdle to managing funds that are to be targeted at the EU from outside the EU. This contrasts with the position of EU incorporated and EU managed funds which are able to give a single notification to their home state authorities to enable them to passport across the whole EU.

So, this state by state requirement could, depending on how onerous it is in practice, act as a significant disincentive to moving fund operations outside the EU where EU investors constitute an important market.

If fund managers are going to find it difficult effecting a total relocation to outside the EU, will they be able to minimise the impact of the Directive on their business by establishing feeder fund structures that comply with the Directive but which then invest in master funds that are completely outside the Directive? The answer at first glance would appear to be no. The Directive as drafted withholds the EU-wide passport arrangement from feeder funds if master funds into which they invest would not be eligible for the EU passport. However, a feeder is a fund that invests 85% of its assets in one or more masters with "identical investment strategies". So one could envisage structures being developed to get around the exact terms of the restrictions – or indeed some form of parallel investment structure being developed for EU and non-EU investors to try to avoid the extraterritorial reach that the Directive could otherwise achieve. If such structures are widely and successfully adopted, this would be to the disadvantage of Europe generally and the UK in particular as, assuming other jurisdictions do not follow the EU to greater regulation, funds may well decide to locate the minimum amount of fund and fund management operations in the EU to facilitate an EU offering.

The other point to note in this regard is that whilst the AIFM will need to be in the EU and fully subject to the AIFM to obtain the ability to sell funds freely to an EU investor base, this does not mean that all management staff involved in managing private funds will need to be in the EU. It is not clear exactly which entity will class as the AIFM in all structures – although it appears that it will be the legal entity that is principally contractually obligated to provide risk and fund management services to AIFs. Potentially if UK tax rates remain high for a sustained period, one can therefore see a scenario where a fund management operation continues to be based in London but where some of the higher paid fund managers look to locate elsewhere and provide their input remotely – potentially through an outsourcing arrangement, which will be allowed under the Directive, subject to some constraints.

In summary, then, there are no obvious ways for a manager for which the EU is an important investor market, to avoid compliance with the Directive altogether. However, assuming that the EU regime is significantly more onerous than regulatory requirements in the US and Asia, the Directive is likely to lead to managers looking to restructure such that funds managed for non-EU investors are operated away from the EU, perhaps with parallel investment structures where a global fund raising is the aim. Meanwhile, we strongly suspect that the 50% tax rate in the UK, if it is maintained for

long, will lead to many of the higher paid among London's fund manager community looking for alternative locations to base themselves, albeit providing their services at least in part to an EU based AIFM.

### So, what will the rest of the world do?

Although EU politicians point to the G-20 agreement in London in April 2009 as justification for the AIFM Directive, actually that agreement merely states that all systemically important funds should be subject to supervision. So, there is no doubt that what the EU is proposing goes way beyond the G-20 mandate.

Some of what is in the AIFM Directive may well get adopted more widely. We would forecast that transparency requirements for investors will be the principal example of this – mainly because investors around the globe are likely to look to obtain the same levels of disclosure as European investors. However, other elements of the AIFM Directive seem unlikely to get adopted in the US or Asia – for example, capital requirements referable to funds under management, leverage restrictions other than for systemically significant funds and disclosure requirements to investee companies. Consequently, in our view, the EU will be an outlier and these requirements could over time potentially erode Europe's – and specifically London's – position as a major hub for private fund management.

But will other countries, particularly the US, be tempted to retaliate in response to the extraterritorial reach of the Directive, specifically relating to non-EU funds that are sold to EU investors? Recently, US Treasury Secretary Geithner voiced his objections to the AIFM Directive and what he saw as its extraterritorial and protectionist elements, but it is far from clear what, if anything, the US will do about it. After all, the US has its hands full at present trying to get its own domestic legislation on financial reform in shape and through the US Congress. Also, EU authorities could easily point out that they are not alone in threatening to bring forward unilateral legislative measures in response to the financial crisis that could have far reaching global impacts. For example, the so called Volker Rule, which has among its components a prohibition on banks or bank holding companies investing in the US has been proposed by the Obama administration without any international consultation. This rule could conceivably have equally great extraterritorial impact on the funds industry as the application of AIFM Directive. So, despite Secretary Geithner's statements, in our view it is unlikely that the US will take any direct action in response to the AIFM Directive. The much more likely scenario is that both the US and the EU will implement their respective domestic reform agendas in accordance with their respective domestic priorities and the funds industry will be left to implement each and attempt to accommodate their structures and way of doing business accordingly.

Regulators in Asia, who are currently pursuing other reforms and enhancements to their regulatory environment will likely take a more wait and see approach, although the Monetary Authority of Singapore is expected to come out with a consultation paper shortly which will propose changes to the licensing regime in Singapore for fund managers, but nothing on the scale proposed in the EU.

### Impact on service providers

With its requirement for all EU managed private funds to appoint valuers and depositaries, does the Directive represent a bonanza for service providers to the EU funds market? In practice, probably not. First, the initial requirement for valuers to be independent will now only apply for funds / managers whose operations / activities warrant such independence. Consequently, there will certainly be a greater requirement for the services of valuers and auditors than currently, but this is likely to be less of a marked increase in demand than if the Directive had remained as originally drafted.

What of the need to appoint a depositary? Potentially this could have been of benefit to the custody industry – although in reality most securities funds (i.e. those funds where there is a clear role for custody services) already have a depositary and other associated service providers (such as prime brokers) in place. But, the provisions requiring appointment of a depositary come with a significant price tag for the custody industry. The relevant provisions state that the depositary is liable for the loss to the portfolio unless it can show abnormal and unforeseeable circumstances beyond its control. Effectively then, this constitutes a force majeure standard. This has proved one of the most difficult provisions to modify – Legislators seem convinced that somehow such a provision could have prevented the Madoff scandal. Assuming we get a Directive that includes a provision like this, what seems certain is that some custodians will choose not to do this business and those that do will increase their prices, thus leading to less choice and increased costs for funds and their investors.

### Restructuring as other forms of vehicle?

A further foreseeable development is funds seeking to recharacterise themselves in some way to avoid the relatively onerous obligations proposed by the AIFM Directive. Consequently, it is possible to foresee, over time, more segregated account / portfolio management structures being established for EU investors to co-invest alongside other structures, possibly set up as funds, for other investors. Also, more structures that can be established as issuances of bonds, notes or other forms of securities could be envisaged. This would allow a structure to take advantage of the private placement exemptions to the Prospectus Directive or potentially for an issuer to issue a compliant Prospectus or obtain a listing – both of which are more tried and tested routes than the AIFM Directive. However, care will need to be taken here as the definition of a fund that is caught by the Directive is very wide and could potentially catch a company established for investment purposes even if it issues securities to investors that comply with Prospectus or listing requirements.

## Conclusions

So, in conclusion, we see the AIFM Directive as leading to some level of restructuring of the European funds industry. We foresee more use of UCITS and other structures that are not classed as funds. At the same time, we see some level of restructuring of private fund models and structures to minimise the impact of the Directive. This is likely to mean a relocation of some activity outside of the EU. At the same time though, some managers for whom an EU investor base is important are likely to look to set up a sufficient level of operation in the EU to obtain the benefit of the EU single passport whilst keeping non-EU targeted funds outside of the EU and setting up parallel investment structures.

We do see a levelling up of disclosure and transparency standards globally. However, in our view this would have happened anyway due to investor pressure internationally. But we also see an inevitable raising of costs that fund managers will likely seek to pass on to investors. Some of these costs will result from extra regulatory costs relating to compliance with the Directive. Less obvious will be costs relating to restructuring funds to avoid the Directive's impact and higher custody costs due to the proposed liability standard.

One final word of caution, the comments in this article and the description of the contents of the Directive is based on the latest Spanish presidency compromise text of the Directive at the time of writing, and there remains significant work to be done between the Council of Ministers and European Parliament to reach a finally agreed text of the Directive. There is at least a possibility that the final Directive will be even worse / more restrictive for the industry than the text on which this article is based. Consequently, industry participants should not rush to restructure their operations just yet. However, fund industry players are going to need to consider very carefully how to structure their operations going forward once the final terms of the Directive are known.

---

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to [nomorecontact@cliffordchance.com](mailto:nomorecontact@cliffordchance.com) or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ.

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571.

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications.

[www.cliffordchance.com](http://www.cliffordchance.com)

---

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Kyiv ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Prague ■ Riyadh\* ■ Rome ■ São Paulo ■ Shanghai ■ Singapore ■ Tokyo ■ Warsaw ■ Washington, D.C.

\* Clifford Chance has a co-operation agreement with Al-Jadaan & Partners Law Firm