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Regulation

European Alternative Funds: The Alternatives

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The alternative investment funds industry is currently facing significant regulatory and legal challenges and, particularly for fund promoters seeking access to European investors, 2009 may well prove to be a watershed. Traditionally, the European (and U.S.) alternative investment funds industry has embraced the offshore jurisdictions as providers of tax-efficient and regulatory "light-touch" domiciles for fund and management structures. The Cayman Islands, in particular, has become the "path of least resistance." Cayman Islands fund and management structures are easily understood, comparatively cheap and underpinned by a respected common-law judicial system. Most importantly of all, from a European perspective, the marketing of Cayman funds in the United States and Europe is relatively simple, with private placement rules often enabling professional investors to invest into a Cayman Islands vehicle with little or no resulting regulatory burden on the fund. Add to these factors the inevitable industry inclination toward well-established precedent—and the critical mass eventually resulting from this—and it is not difficult to see why approximately 80 percent of all hedge funds are registered in the Cayman Islands.

However, alternative investment funds have recently become subject to hitherto-unseen levels of scrutiny from regulators, politicians, tax authorities and investors, even though much of the resulting criticism has been unwarranted (other than in terms of underperformance). Few participants in the financial services industry seriously believe that the global financial crisis was caused by hedge funds, and this scepticism has been endorsed by more than one regulator. Nevertheless, certain axes are now being held firmly to the grindstone. In this political climate, the future of the "unregulated" offshore jurisdictions is far from certain, and their role as significant financial centers may be substantially altered by forthcoming legislation and regulation, as well as investor demand.

The Alternative Investment Fund Managers Directive

In relation to funds that concentrate on the European market, draft legislation has already been produced by the European Commission. Hot on the heels of the London meeting of the G20 group of governments, the Commission on April 29 published a proposed Directive on Alternative Investment Fund Managers (AIFM Directive). The severity of this proposed directive and the speed (some would say "haste") with which it was produced have caught many in the industry by surprise. Among several other wide-ranging provisions, the AIFM Directive, as drafted, extends direct regulation in the EU to fund managers of all alternative funds. An alternative fund is defined, for these purposes, as being any fund, open or closed, that is not a UCITS (a UCITS, as further discussed below, being the EU equivalent to a U.S. registered mutual fund). Accordingly, the definition is extended to not only hedge funds but also private equity funds, real estate funds, commodity funds and any other classes of funds other than UCITS.

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In addition, much of the regulation imposed by the AIFM Directive has been indirectly extended to funds themselves (for example, the AIFM Directive demands certain levels of disclosure to regulators and investors, requirements for liquidity management and limits investment in certain securitised positions, among other things). The quid pro quo for this additional level of regulation is that a pan-EU marketing passport will be introduced for alternative funds for the first time. In theory, this should simplify and facilitate the marketing of alternative funds to European investors, save for the crucial fact that the passport is not available to non-EU domiciled funds for the first three years following the directive's commencement and thereafter only in certain circumstances. Some commentators have regarded this as a step toward protectionism, especially as it was introduced at a comparatively late stage in the drafting of the AIFM Directive, and it may well result in a bias among promoters toward EU-domiciled products that can easily be availed of the marketing passport. Moreover, it is unclear whether the existing European private placement rules will survive the passage of the AIFM Directive, even for funds whose investment manager is based outside the EU. If not, an EU-domiciled, regulated product may become the only practical option for promoters seeking to market alternative funds to European investors.

Alongside increased regulatory scrutiny, there has also been a move in the last couple of years to attract a greater proportion of investment from sustainable long-term institutional investors. Combined with an investor-led "flight to quality" resulting from the poor performance of many funds during 2008 and the perceived liquidity mismatch within the hedge fund sector, this has led to an increasing interest in the onshore, "regulated" alternatives for alternative fund products.

The UCITS

A promoter looking at the EU onshore hedge funds industry has an initial threshold question: should the fund be a UCITS or not? A UCITS (Undertaking for Collective Investment in Transferable Securities) is the form of fund structure available for pan-European marketing to a retail and institutional client base and one that accounts for the vast majority of assets under management in Europe. Significantly, therefore, the largest pool of available capital is earmarked for investment into UCITS and, as such, it may pay to make a product UCITS-compliant. However, because it is designed primarily as a retail product, the fund must first comply with extensive operational and investment regulations. Among others—

- The fund must be established in the European Economic Area.

- The fund, its promoter and its manager must each be authorized within an EU member state (the promoter and the manager are often one and the same). In general, the manager of a UCITS must also be domiciled in the same jurisdiction as the UCITS itself, but regulatory authorities are permitted to allow (and in practice have allowed) deviation from this where a manager is based in a jurisdiction with equivalent regulation. As such, a U.S.-based investment manager may manage a UCITS, provided that it (1) is a registered investment adviser with the SEC, and (2) that it meets the prescribed requirements in the relevant EU state (including capital adequacy, risk monitoring and other local regulations) and has obtained approval from the regulator of the country in which the UCITS is located (e.g. the Irish financial regulator).

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- Capital adequacy rules mean that a UCITS manager must have an initial share capital of at least €125,000 and, where the manager's assets under management exceed €250 million, the manager must provide additional capital at a rate of 0.02 percent of the excess, subject to a cap of €10 million (note that, under the Capital Adequacy Directive and certain local regulatory regimes, European investment managers are already subject to capital adequacy requirements, and separate capital adequacy rules are proposed under the AIFM Directive, so this may no longer be a significant disadvantage). In addition, the promoter of a UCITS may be subject further to capital adequacy rules. For example, in Ireland, a UCITS promoter is required to have minimum shareholder funds of at least €635,000. Finally, a self-managed UCITS (meaning management of the fund itself, rather than investment management—and, as such, typical of most fund structures) must have an initial capital of €300,000, although this may be repaid to the party providing the initial capital upon receipt of subscriptions by investors in the fund.

- Risk-monitoring requirements are imposed on UCITS managers and risk-spreading requirements apply to UCITS investments. For example, a UCITS may not generally invest more than 5 percent of its net asset value in securities of the same issuer or connected issuers, or derivatives linked to these (although this may be increased to up to 10 percent of net asset value in certain circumstances).

- Up to 10 percent of the net asset value of a UCITS may be invested without restriction. However, the remaining 90 percent is confined to a prescribed list of permitted investments, including
  - » transferable securities admitted to the official list of a stock exchange or which are dealt in on a regulated, liquid, recognized market that is open to the public and operates regularly
  - » up to 10 percent of net asset value in recently issued transferable securities (with the exception of certain U.S. securities) that fall within either of the above categories within a year
  - » money market instruments, units of other UCITS and certain non-UCITS (but, in practice, not Cayman Islands hedge funds), deposits and certain derivative financial instruments, including covered options, futures, currency forwards, swaps, contracts for difference and credit default swaps. In general, derivatives used by a UCITS may not reference assets in which the UCITS is not permitted to invest directly.

- The fund must appoint an EU-domiciled depository, typically a custodian or trustee, that will be responsible for the safekeeping of the fund's assets on behalf of investors. However, the depository may sub-delegate its functions to a third-party prime broker, including a prime broker based outside the EU.

- The maximum redemption period is typically limited to 14 days, and redemption limitations such as the "gate" are restricted.

- Fund borrowing is restricted to 10 percent of net asset value, and then only on a temporary basis and not for investment purposes. However, following the recent relaxation of permitted investments, in practice a UCITS may leverage itself up to 100 percent of its net asset value by the use of certain derivative

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instruments. In addition, if a UCITS is classified as "sophisticated" by its regulatory authority (based on the risk-management processes it employs), then this limit is replaced by a value at risk limit of 20 percent, or twice benchmark value at risk, if lower.

Since the implementation of UCITS III (a significant amendment to the original 1980s legislation), it has, due to the expanded use of derivative instruments, been possible to create a form of absolute return fund under the directive, and there is an increasing trend towards doing so. Funds with less-liquid investment strategies, such as distressed debt funds, will generally be unable to comply with the UCITS investment restrictions. In addition, funds that employ high levels of leverage or that have irregular liquidity or lock-ins will generally fall short of the UCITS regulatory requirements and, so, will not be compatible with the UCITS model. Managers that are not registered with an approved regulator (e.g., the SEC) will also struggle to obtain approval.

However, many hedge fund-type strategies will be compatible. Therefore, it is possible that there will be an increase in the number of hedge fund managers seeking to fit their existing strategies within the UCITS model or seeking UCITS-approval of modified versions of these strategies. This may result in managers running largely the same strategies in adjacent UCITS and non-UCITS funds.

EU-Domiciled Hedge Funds

Outside the UCITS model, promoters have, for a number of years, been able to establish single-strategy hedge funds within various EU member countries. For example, Luxembourg and Ireland have "professional investor"-type products and, alongside relative newcomer Malta, have become the homes of the "onshore" hedge fund. These jurisdictions offer low rates of taxation, including, in some cases, a full corporate tax exemption. Seeking to build up their local hedge fund industries, national legislators have been proactive in providing appropriate legal structures and favorable regulatory regimes.

In Ireland, the Qualifying Investor Fund (QIF) requires a minimum contribution per investor of €250,000, along with a self-certified wealth test. QIF hedge funds may take the form of a variable capital investment company, a unit trust or a (tax-transparent) common contractual fund. A QIF is exempt from all investment and borrowing restrictions normally imposed by the Irish regulator. A regulatory framework specifically targeted towards hedge funds has also been developed, enabling the use of prime brokers and short selling, subject to certain relatively straightforward conditions. The Malta equivalent to the QIF is the Extraordinary Investor Fund (EIF), which requires a minimum investor contribution of just €150,000, along with a similarly self-certified wealth test. Hedge funds will most commonly take the form of a SICAV, the Maltese equivalent of an open-ended investment company. An EIF is not subject to any investment restrictions or risk-spreading requirements. In Luxembourg, the Specialized Investment Fund (SIF) also requires a minimum investor contribution of €150,000, although the SIF does impose a general investment limit of 30 percent of the fund's net asset value per issuer, and assets must generally be invested in accordance with risk-spreading principles.

In addition, national fund industries in Luxembourg, Ireland and Malta, with the sanction of responsive authorities,

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have sought to reduce regulatory burden still further. For example, in response to requests from industry participants, Ireland has now introduced a self-certified fund regulatory regime, cutting the time required to obtain authorization to just 24 hours. In Malta, initial formation costs have been intentionally set at a low level, in an effort to attract fund start-ups. The wide range of local service providers in Ireland, Luxembourg and Malta, including those of administrators, counsel and accountants, is an added advantage.

It is also possible to establish single-strategy hedge funds in a significant number of other EU states including Denmark, Finland, France, Germany, Italy, the Netherlands, Portugal, Spain, Sweden and the United Kingdom, although regulatory, operational and tax issues have meant that none of these jurisdictions has, as yet, emerged as a domicile of choice. In practice, without a significant shift in the relevant regulatory or taxation regimes, these jurisdictions are unlikely to present an attractive fund domicile unless a promoter is forced to operate there to fulfil the demands of a particular group of investors.

Listings and Permanent Capital Vehicles

As a further means of broadening the potential investor base, promoters may also wish to consider a listing on one of the European stock exchanges. Until recently, the Irish Stock Exchange dominated European hedge fund listings, although, in practice, this was a "passive" listing of an open-ended fund's shares, with the net asset value quoted but no secondary market trading occurring. Listing has the effect of adding an EU regulator's oversight even though, in fact, the Irish regulator does not sign off on the fund's offering document. Nevertheless, the Irish Stock Exchange is a regulated market, and, as such, funds are compelled to comply with various transparency and governance rules to maintain a listing. Listing also enables investment by certain institutional investors that are required to invest in listed securities.

One onshore alternative has been to establish a closed-ended fund as a permanent capital vehicle acting as a feeder into an existing offshore fund. Although these funds are generally established in the offshore jurisdictions, they are then listed on one of the main European stock exchanges, such as Euronext, the London Stock Exchange or, more recently, the LSE's Specialist Funds Market. Investors in such funds would achieve liquidity by use of the secondary market and, when desiring an exit, would seek to trade their shares on-market. Although some established fund managers have gone down this route, the extra regulatory constraints of maintaining a publicly listed vehicle together with the problem of what to do when secondary market liquidity dries up, as well as the age-old issue for investment companies of their shares trading at a discount to net asset value, have meant that others have been reluctant to follow their lead.

Conclusion

Several years have now passed in which European legal and regulatory structures have been extensively developed and improved in an attempt to attract fund promoters to set up within the EU, with little initial success. The exception to this is the UCITS, which has developed global recognition as a class of fund in its own right but made little impact on the alternative investment funds market. However, the global financial crisis has created a political environment in which the status quo is no longer tenable and the offshore funds industry has, perhaps unfairly, been subject to severe scrutiny and criticism. In light of this and the resulting proposed

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AIFM Directive, many industry participants are predicting that the "regulated," onshore industry will now experience a significant increase in its assets under management and diversification of its product base, spanning both UCITS and non-UCITS models. In this rapidly evolving environment, fund sponsors and other industry players should pay close attention to political and investor attitudes, position themselves to respond quickly and expect innovation to be the order of the day.

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