The AIFM Directive

A Preqin Special Report

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Background

The first draft of the AIFM Directive was presented by the European Commission in April 2009. Its purpose is to subject private equity and hedge funds to greater scrutiny and to protect investors in these funds. The Directive will form a regulatory framework for collective investment undertakings, other than those covered by UCITS, and will apply to fund managers residing within the EU along with funds domiciled or marketed in the area. The Commission estimates that 30% of hedge fund managers, managing almost 90% of the assets of EU-domiciled hedge funds, and almost half of the managers of other non-UCITS funds will be affected by the Directive. The legislation will also impact on some alternative investment fund managers managing infrastructure, real estate, commodity, investment trusts and non-UCITS retail funds.

Industry professionals had three main concerns when the first draft was presented. Firstly, the Directive stated that portfolio companies would have to disclose commercially sensitive information; secondly, it set high capital adequacy requirements; and thirdly, the measure that caused the most anxiety, non-EU fund managers would have to register with each individual European member state if they were to market to investors in the country.

Some issues proved to be less potentially harmful than initially anticipated. For example, portfolio companies are not required to disclose more information than is already necessary in the majority of member states. However, concern remained over fears that a European lock-in/lock-out would be created.

It was not until October 2010, under the Belgian presidency, that a compromise was reached. A European Passport scheme was proposed, which would enable fund managers to conduct business in each member state through one registration, rather than having to register with each country individually. After initial reticence from France and Germany, the amendment was agreed in mid-October, before the motion was passed in a vote by the European Parliament on 11th November.

There is still a lot of negative feeling towards the Directive amongst industry professionals, financial commentators and certain political figures, but the latest draft is felt to be a lot more acceptable than the initial version presented in April 2009. This report will examine the predicted impact the AIFM Directive will have on the sector, and capture fund manager sentiment as they prepare for the biggest change in the history of the alternatives assets industry in Europe.

Methodology

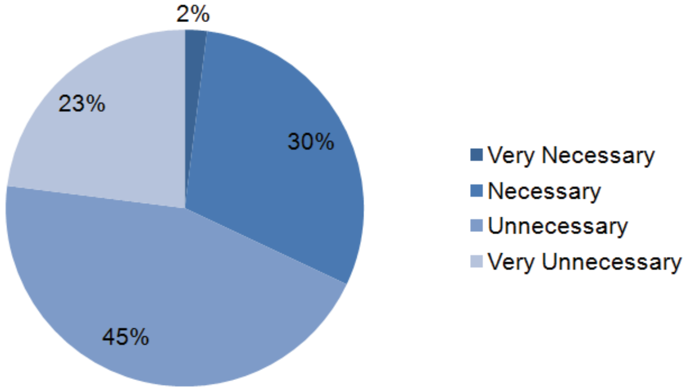
A two-part email survey was sent out to European-based fund managers and investors. The first section consisted of seven multiple choice questions, and respondents were asked to rate the necessity and perceived severity of the key aspects of the AIFM Directive proposal.

In the second part of the survey, respondents were invited to discuss in further detail their opinions on certain parts of the legislation, as well as provide general feedback on the Directive. Results were collated and are analysed in-depth in the report which follows.

How necessary do you believe the Directive to be?

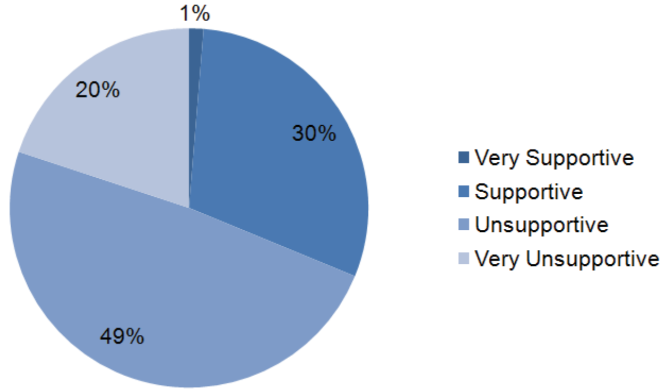
32% of respondents believe the Directive to be either very necessary or necessary, as shown in Fig. 1, while the remaining 68% believe it to be very unnecessary or unnecessary. Commenting on the need for the legislation, one respondent stated, "The Directive is somehow a necessary step for a more

Fig. 1: How Necessary Do You Believe the Directive to Be?



Source: Preqin

Fig. 2: To What Extent Are You Supportive of the Directive?



Source: Preqin

integrated market inside Europe and a necessary evil," while another claimed, "It is a necessary document that could be good for the industry if it is properly formed."

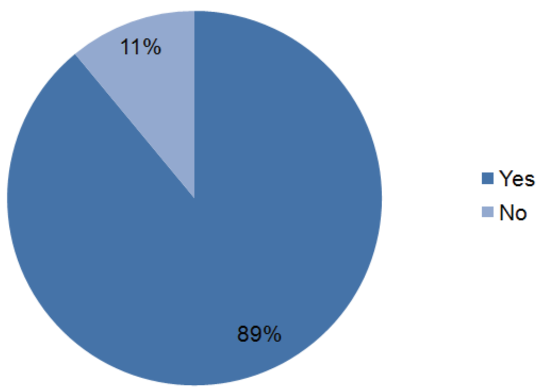
The large majority of opinions voluntarily offered on this subject were negative. One respondent stated, "It is not addressing fundamental industry concerns, but is creating a regulatory environment that may change the way people invest," while another suggested, "It is a badly drafted piece of legislation aimed at solving a problem that does not exist." A third claimed that the industry would be able to learn its own lessons and that self-regulation would be more favourable: "In general, any interference by public authority in a developed and efficient market seems unnecessary to me. Investors will learn their lessons from the past two years, and this will be translated into their future investment strategies, forcing private equity funds to review their aggressiveness and long-term strategy."

That the Directive is politically motivated is the main cause for concern amongst those participating in the survey. One respondent stated, "Initially it was a poorly thought through 'knee jerk' bit of political legislation. This has been clearly demonstrated by the numerous compromises required to get it to the current state." Another wrote, "It is too politically driven and not written by industry professionals," with this view supported by a third respondent, who claimed, "It is unnecessary and entirely politically driven, it will make some politicians look good but it has no beneficial impact on the stability or risks of the European financial market in general, nor the European private equity market in particular." One more simply stated, "[It is] politically-driven nonsense," and sharing this sentiment, another claimed, "[It is] a political mess and irresponsible populists' manipulation for easy sympathies of uninformed voters."

To what extent are you supportive of the Directive?

As shown in Fig. 2, 69% of respondents were either unsupportive or very unsupportive of the Directive, with the remaining 31% stating a degree of support for the legislation.

Fig. 3: Should the Directive Be Amended to Further Take Into Account the Differences Between the Various Asset Classes?



Source: Preqin

Several participants expressed their support for the Directive when given the opportunity. One stated, "It's good to have the rules in place, and the Directive contains more pros than cons," while another said: "I'm carefully positive, since I see a great probability of increased transparency and less tax evasion as a result of the implementation of the Directive. Further, I regard it useful for everyone to acknowledge the cons of excess leveraging and the possibility of a systemic risk, albeit mostly in extreme cases only." One respondent commented, "We are supportive and the outcome is better than feared."

Others were keen to discuss their lack of support for the Directive and a variety of reasons for their negativity were put forward. One stated, "I'm not supportive of the legislation; it's taking a hammer to a nut. The venture capital community will be hit as collateral damage, and innovation in Europe will be greatly damaged as a result. The basic premise of the Directive is flawed." Continuing on the same theme, another claimed, "In the context of private equity it is something of a sledgehammer to crack a nut. Various measures will increase costs without any tangible benefits. I do not support the Directive."

Should the Directive be amended to further take into account the differences between the various asset classes?

The vast majority of respondents, 89%, believed that the Directive should be revised to make more allowances for the differences between the various asset classes, as illustrated in Fig. 3.

One stated, "The Directive does not take into account the various types of funds, such as private equity and venture capital funds, and therefore creates additional burdens on firms which did not contribute to the financial crisis."Another supported this view, claiming, "It is poorly conceived, relating to two business models – private equity and hedge funds – that are completely different. The rules for one are not relevant to the proper regulation of the other and vice versa. This is therefore a true demonstration that politicians are more concerned with their egos and local popularity than maintaining a European industry that happens to have a predominance in a small number of EU states." A third stated that the committee should start again, and draw up separate legislation for the various asset classes, thereby making it more specific and directed at the relevant concerns.

Suggestions of ways in which the Directive could be altered to allow for the variations between the asset classes were forthcoming. Numerous respondents stated that venture capital firms should not have to comply with the legislation, while a significant number stating that the capital requirement clause needed to be re-considered to take into account the varying levels of operating costs to which firms are exposed.

Likelihood that the Directive will create a European lock-in/lock-out

One concern repeatedly expressed by commentators, journalists and industry professionals alike since its conception is that the Directive will create a European lock-in/lock out as non-EU fund managers will be exposed to the same level of scrutiny as those domiciled in the region. The survey asked how likely respondents believed it was that this concern would materialize. 59% believed it is very likely or likely that the Directive will have this effect, while the remaining 41% thought it an unlikely or very unlikely consequence.

A few respondents raised related points. One stated, “International investors will think twice before investing in slow-growth Europe,” while another claimed, “The restrictions will be off-putting for non-EU investors and fund managers.”

Likelihood of fund managers relocating to outside of Europe

45% of those surveyed stated that it was likely or very likely that fund managers will relocate to outside of the EU, while a small majority, 55%, believe that this is an unlikely consequence of the Directive, as shown in Fig. 5. Interestingly, when asked the same question about their firm specifically, a higher proportion of respondents, 74%, stated that it was very unlikely or unlikely that they would move outside of Europe, with the remaining 26% stating that it is likely or very likely that they will do so. A breakdown of the results is shown in Fig. 6.

Participants were keen to discuss the potential movement of both fund managers and investors following the implementation of the AIFM Directive. One respondent stated, “The alternative assets industry will move to the Far East,” with this view supported by another that stated that the movement of both money and money management to the East was likely in the long term as investors and fund managers look to avoid the extra regulatory burden.

Numerous other respondents also believed that there will be movement out of the EU. One stated, “Firms will be driven outside of the EU,” and another suggested that “there will be far fewer EU venture funds, and the money will flow outside of the area too.” Speaking in reference to his firm specifically, one manager stated, “At one point we may need to establish a US presence.”

Which measure will have the biggest impact on the industry?

Respondents were asked which single measure within the AIFM Directive they believe will have the biggest impact on the alternative assets industry. The results are shown in Fig. 7, with 28% of respondents stating that the introduction of the EU passport and concurrent phasing out of private placement rules will have the greatest impact. 22% stated that the requirement that non-EU fund managers comply with the Directive will have the biggest effect, while a similar proportion believe disclosure requirements will have the largest effect. The smallest number of respondents felt that increased regulations relating to retail investors will have the greatest impact on the industry, with just 3% choosing this option.

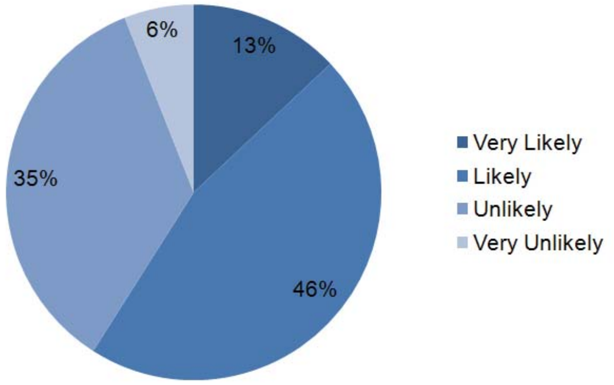
Several respondents discussed the liquidity requirements set out in the Directive, stating that they would be prohibitive to business. One stated, “Cash reserves set at 25% of annual costs are not fair to smaller funds as this money is needed for operations. This rule should be excluded for those funds with less than €500 million under management,” while another supported this view, claiming: “Capital requirements should be reduced and venture capital should certainly be excluded entirely.”

The EU passport scheme was also cited as a source of discontent by those surveyed. One respondent stated, “The passport idea is idiotic; marketing of financial products between major financial markets should be free.” Several respondents expressed concerns that the system would not be put into practice swiftly. One said, “Will the EU passport be implemented quickly and efficiently? I’m not sure,” while another stated, “I hope the EU financial and regulatory bodies will prepare well in advance standard and uniform model documents for the various member countries to copy at the implementation, especially for the application for the passport.”

Other Points

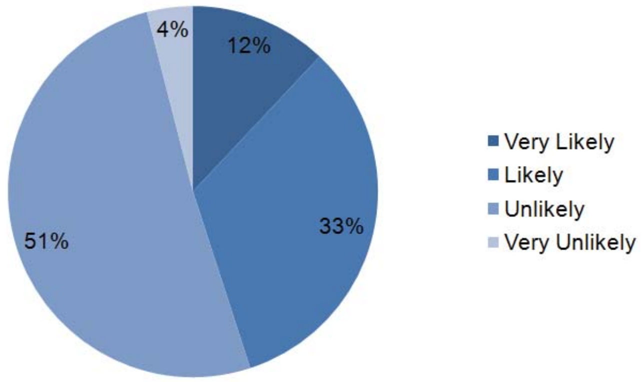
In addition to those already discussed, several recurring points were raised when respondents were invited to offer general comments on the Directive. While many stated that the regulations were unnecessary and too restrictive, a number noted that the alternative assets industry in their country would become less severely regulated once the Directive was implemented. One fund manager said, “Our firm will be significantly better off, given that the current Croatian legislation of the private equity

Fig. 4: How Likely Is it That the Directive Will Create a European Lock-In/Lock-Out?



Source: Preqin

Fig. 5: Likelihood of Fund Managers Relocating Outside of Europe



Source: Preqin

industry is more restricted than Directive." Another claimed, "Italy will probably drop the minimum threshold for investing in onshore Italian hedge funds. It could also open up the market to funds domiciled in more dynamic and less burdensome EU countries."

There was mutual concern about the additional costs firms would face once the Directive becomes law. Comments received included: "We will face more administration and extra costs, and greater hassle when organizing ourselves for fundraising;" and, "It will make it harder for us to raise funds and will force us to incur completely unnecessary costs." The issue of the impact additional cost will have on profitability was also discussed by a number of participants. One stated, "The industry will continue to grow and play a valuable role within the UK and European economies, but the cost of operating and marketing a fund will rise and therefore returns for the investor will fall," while another commented,

"Returns will deteriorate due to increased costs. Probably quite a few otherwise interested investors will allocate their funds outside of Europe." A third claimed, "All in all, the Directive will increase significantly the costs of the funds and fund managers and create a lot of unnecessary administration-related costs, hence threatening the returns and existence of the industry."

Survey Results: The Industry View

Representatives from the BVCA and the EVCA were shown the survey results and asked to comment.

Simon Walker, Chairman of BVCA, said, "What this excellent and much-needed report demonstrates is the needless damage the AIFM Directive will inflict upon the private equity and venture capital industry. Neither asset class has been shown to have contributed to the financial crisis in any way, yet they are now faced with increased costs and disproportionate burdens. This is particularly disturbing for the larger venture capital houses, a set of institutions the European Union can ill-afford to stifle if it is serious in its efforts to encourage innovation and entrepreneurship.

"There are many sections in the agreed text which remain ambiguous, inconsistent or incoherent. This means that the detailed procedure for translating this Directive into national law becomes unusually important. The BVCA along with the EVCA will dedicate much of the next two years to a forensic involvement in the critical implementation phase of this exercise."

Chairman of the EVCA, Javier Echarri said, "Despite the politically-charged birth of this Directive, almost a third of practitioners actually support it. This is testament to the sensible improvements achieved but it also suggests a stoic acceptance by practitioners that no financial player has escaped EU regulation, and in a post-financial crisis world, an industry that bridges the financial and real economies, can benefit from being seen to operate under the most stringent of international standards.

"The lack of tailoring was this Directive's biggest flaw. There is a lesson here for all architects of financial legislation: it must either be broad and principles-based to allow for sensible application, or specific and tailored. AIFMD was neither one thing or the other, and what tailoring there is for our industry was only achieved through painstaking dialogue."

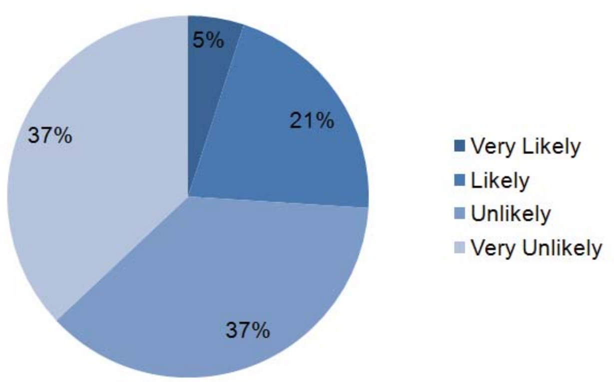
Summary

The initial announcement of the terms of the AIFM Directive triggered an avalanche of condemnation, and despite numerous amendments being made, controversy continues to surround the legislation more than 18 months after its inception.

While it is clear that the Directive is unpopular within the alternative assets community, the results of the Preqin survey suggest that there is a certain level of support for the legislation, with just under one-third of respondents stating that they back it to some extent.

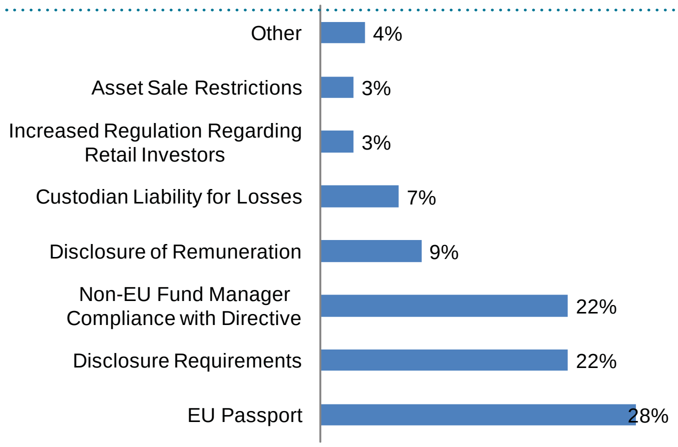
A lot of the criticism levelled at the Directive is politically motivated, so it could be argued that those with negative feelings about the EU as a legislative body are exhibiting some bias in their disapproval. However, the recurring concerns of those

Fig. 6: Likelihood That Your Firm Specifically Will Relocate Outside of Europe



Source: Preqin

Fig. 7: Which Measure Will Have the Biggest Impact on the Industry?



Source: Preqin

participating in the survey relate to matters such as the lack of differentiation between the various asset classes, the negative impact it will have on innovation due to the liquidity requirements to which venture capital funds will have to adhere, and the fact that the legislation has been constructed by politicians with little or no understanding of the alternative assets industry. It seems reasonable to conclude that fund managers and investors would be appeased if the document were to be revised by an objective third party.

Only time will tell if the predicted impact of the AIFM Directive will materialize, and whether or not the concerns of alternative investors and fund managers are justified in the long term. What is evident now however is that the AIFM Directive will elicit the most radical reform of the alternative assets industry in Europe to date, and its implementation will have far-reaching and long-term consequences for all stakeholders in the sector.

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