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The New Draft Directive on Hedge Funds: A Sting in the Tail for the ABS Market

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On 30 April 2009, the European Commission (the "Commission") released its widely anticipated draft Directive on Investment Fund Managers (the "Draft Directive").[1] If implemented in its current form, the Draft Directive will not only have an immediate impact on hedge funds but also on the asset backed securities ("ABS") market. The new requirements will be particularly onerous for the CMBS and RMBS markets.

The ABS market is very familiar with the proposal from the E.U. for originators and/or sponsors to retain at least 5 per cent. of any of their related ABS issuances. This will be imposed by an amendment to the Capital Requirements Directive.[2] Penal regulatory capital charges will be levied on regulated E.U. credit institutions that do not obtain an explicit commitment from the related originator, sponsor or underwriter that such parties will maintain a material net economic interest of not less than 5 per cent. in securities of the same tranche or tranches acquired by such credit institution. However, the Draft Directive signals that a new front is being opened by the E.U. in their efforts to regulate the ABS industry by limiting the type of ABS assets in which hedge funds and similar entities may invest.

To Whom Will It Apply?

The Draft Directive introduces a number of new concepts:

- Alternative investment funds ("AIFs") are collective investment undertakings, including their compartments, the objects of which are the collective investment in assets (and which are not credit institutions, pension funds, insurance or reinsurance undertakings, a supranational or international institution or organisation nor required to obtain authorisation pursuant to the upcoming UCITS Directive).
- Alternative investment fund managers ("AIFMs") are legal or natural persons whose regular business is to manage one or more AIFs.

The Draft Directive will apply to any AIFM that:

- is established in the European Community;
- provides management services to any AIF or markets units or shares of any AIF to professional investors (as set out in Annex II of Directive 2004/39/EC[3]) in the European Community; and
- directly or indirectly manages portfolios of AIFs, the aggregate assets of which exceed either:

  (a) 100 million Euro; or

  (b) 500 million Euro (if the managed AIFs are neither leveraged nor grant investors redemption rights during

the first five years from the date of the AIFs' constitution).

The Draft Directive will also potentially apply to AIFMs formed outside of the E.U. providing management services or marketing units or shares of an AIF to professional investors in the Community.

How Will the ABS Industry Be Affected?

The Commission will be implementing measures designed to regulate acquisition by AIFs of loan securitisations such as CMBS and RMBS (and presumably CLOs) by establishing:

- requirements to be met by originators of such securitisation issuances in order for an AIFM to be permitted to invest in these securities or other financial instruments issued after 1 January 2011 (such as the requirement that such originators retain a 5 per cent. net economic interest in the issuance); and
- qualitative requirements to be met by the AIFMs that invest in these securities or financial instruments on behalf of one or more AIFMs.

Once these areas of regulation are developed, originators and/or sponsors involved in loan securitisations such as CMBS and RMBS that target AIF investors will need to retain a 5 per cent interest in their related securitisations. As a result of this, non-E.U. loan securitisations seeking to access the European investor market will need to comply with these rules.

Any AIFM that does not comply with these requirements may have its authorisation to carry on business within the E.U. withdrawn and may face criminal sanctions at a national level. It is notable that this is a relatively cumbersome enforcement mechanism compared to the proposed changes to the Capital Requirements Directive discussed above.

Conclusion

At a time when many are commenting on the need to increase the availability of credit to boost economic activity, it seems contradictory for regulators to restrict the availability of ABS, which is one of the principal mechanisms for banks and other lenders to finance their lending activities. It is also difficult to see the policy underlying restricting the ABS investment activities of private vehicles backed by wealthy and sophisticated investors.

The Draft Directive is the first stage of a process of consultation with interested parties that, when completed and the final form of the directive is enacted, will be followed by an implementation process at the national level. Paul Hastings will issue further Client Alerts with any significant changes that arise concerning this issue.

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[1] http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_impact_assessment.pdf.

[2] Directive 2006/48/EC and Directive 2006/49/EC.

[3] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF