

INVESTMENT FUNDS ALERT

PROPOSED CHANGES TO THE EUROPEAN REGULATORY LANDSCAPE: THE DRAFT DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS

INTRODUCTION

On April 29, 2009, the European Commission released a *Proposal of the European Parliament and of the Council on Alternative Investment Managers* (the “Proposed Directive”). A commentary on the Proposed Directive by the Commission has been published and can be found on the [Europa Web site](#), along with responses to certain “[frequently asked questions](#).”

The Commission produced the Proposed Directive as a consequence of increasing political pressure following the financial turmoil of recent months. The Commission intends to create a consolidated EU regime for the regulation and oversight of alternative investment fund (AIF) managers. This represents a significant change in the regulatory landscape for all fund managers based in the EU and potentially beyond.

In particular, the Proposed Directive places regulatory constraints on all investment funds (open-ended or closed-ended) managed from Europe that are not registered as a UCITS (Undertakings for Collective Investment in Transferable Securities). The Proposed Directive will therefore be of importance not just to hedge fund managers but also to managers of private equity funds, real estate funds, infrastructure funds, venture capital funds, permanent capital vehicles and futures funds.

The political process leading up to the publication of the Proposed Directive has proven controversial. In addition, the text of the Proposed Directive has been produced in very short order and will require refinement to avoid a number of unintended consequences being enshrined in law.

SUMMARY OF CERTAIN PRINCIPAL ASPECTS OF THE PROPOSED DIRECTIVE

- **Authorisation.** Subject to a de minimis exemption (assets under management in aggregate not in excess of €100 million, or €500 million for managers managing AIFs that do not employ leverage and have a lock-in period of at least five years) the managers of all non-UCITS funds, even those funds domiciled outside the EU,

will require authorisation by a home state regulator in accordance with the Proposed Directive in order to manage or market AIFs in the EU. It appears that those firms that just advise but do not either exercise discretionary management or market the funds would not be subject to the Proposed Directive, although clarification on this point will need to be sought. In order to be authorised, the AIF manager will be required to satisfy certain standards relating to, amongst other things, the robustness of internal arrangements with respect to risk management—in particular, liquidity risks and additional operational and counterparty risks associated with short selling, the management and disclosure of conflicts of interest, the fair valuation of assets and the security of depository/custodial arrangements.

- **Capital Adequacy.** AIF managers subject to the Proposed Directive will be required to have an initial and ongoing capital of at least €125,000. In addition, where the aggregate value of all of the AIFs managed by an AIF manager exceeds €250 million, the manager will be required to hold additional capital equal to 0.02 percent of the amount by which the aggregate value exceeds €250 million. It is not altogether clear why the act of managing an alternative fund demands a higher capital adequacy threshold than, for example, a UCITS manager, and we expect this issue will be the subject of considerable discussion.
- **Right to manage funds domiciled in third countries.** The Proposed Directive recognises that most fund managers will seek to manage funds established outside of the EU, and this is permitted subject to the following conditions: (i) that the fund be valued by an EU-domiciled “valuator” and (ii) that the assets of the fund be deposited with a “depository” that the AIF manager is able to demonstrate is subject to prudential regulation, ongoing supervision and anti-money laundering rules equivalent to EU law. In addition, the AIF manager can only manage funds that are domiciled in a third country if that country is a signatory to necessary information-sharing agreements with “competent authorities” within the EU.
- **Marketing.** The apparent benefit for AIF managers is that the act of authorisation will allow an AIF manager freely to market funds on an EU-wide basis to “professional investors” (as defined in the EU Markets in Financial Instruments Directive, or MiFID).
- **Corporate Governance.** The Proposed Directive sets out standards for the conduct of authorised AIF managers, many of which would be familiar to firms already regulated by the FSA. Standards are also set out for AIF managers’ relations with investors. In particular, the Proposed Directive provides for a minimum level of service and disclosure to investors, on an initial and ongoing basis, to facilitate due diligence and ensure a minimum level of investor protection. Much of this information would typically be provided in a fund’s offering document. It is not clear from the Proposed Directive whether a fund’s offering document will have to be approved by a home regulator prior to the commencement of marketing.

One additional point to note is that the Proposed Directive will require authorised AIF managers to act in the best interests of “the integrity of the market.” This phrase is not further elucidated, so its practical effect is unclear.

- **Leverage.** Reporting requirements will be imposed on the managers of AIFs using systematic leverage above a certain threshold whereby the AIF manager will be required to provide information to its regulator, and authorities will receive emergency powers to restrict leverage if required. Currently, the Commission holds the view that an AIF employs high levels of leverage on a systematic basis when the combined leverage from all available sources exceeds the value of the equity capital of the AIF on two out of the past four quarters.
- **Portfolio Companies.** Disclosure requirements will also be imposed on the managers of AIFs purchasing a controlling or dominant stake in companies. The disclosure will have to be made to other shareholders in the target company, as well as to “interested parties.” The Proposed Directive also contemplates provisions requiring the AIF manager to issue disclosure on the investment strategy and objectives of its fund when acquiring control of companies, and general annual disclosures about the performance of the portfolio company following acquisition of control. These reporting obligations are introduced “in view of the need for private equity and buy-out funds to account publicly for the manner in which they manage companies of wider public interest.” The Commission adds that “the information requirements address the perceived deficit of strategic information about how private equity managers intend to manage, or have managed, portfolio companies which they own.” Demands for this type of disclosure are made in respect of larger buyout investments and public-to-private transactions. In addition, in reaction to perceived concerns raised with regard to the delisting of public companies owned by private equity funds and the subsequent reduction of transparency, the Proposed Directive requires that such delisted companies temporarily continue to be subject to the reporting obligations for listed companies.

One particular theme running through the Proposed Directive is that, like many attempts to regulate the fund management industry, there is a lack of clarity with regard to the legal distinction between the manager and the fund itself. The Proposed Directive often places demands on a manager that, as a consequence of the typical structure of investment funds and the concept of legal capacity, it is not in a position to carry out. It is not clear how this conflict in the drafting will be resolved. In addition, the Proposed Directive makes no distinctions as to the various types of fund structures, so it is not clear whether the Proposed Directive relates to a master, a feeder, or both.

REMUNERATION

In addition to the provisions of the Proposed Directive, the European Commission’s [Recommendation on remuneration](#) in the financial services sector will apply to an AIF manager that has its registered office or head office in the EU. The Recommendation will apply to all staff having an impact on the risk profile of the financial institution. Directors of AIFs are covered and, to the extent that funds are listed, the more detailed European Commission Recommendation on directors’ remuneration will also apply.

However, fees that the manager charges for providing management services to an AIF are outside the scope of the Recommendation.

CONCLUSION

Numerous political and industry bodies will be commenting on the Proposed Directive over the course of the year, and its path to law is by no means clear, given the political sensitivity of the issue and upcoming European elections. It is also not clear whether it will have the support of all the EU member states. We will report back to our clients on developments as they arise.

CONTACT INFORMATION

If you have any questions regarding this alert, please contact:

Mark H. Barth	mbarth@akingump.com	212.872.1065	New York
David M. Billings	dbillings@akingump.com	44.20.7012.9620	London
J.P. Bruynes	jpbruyes@akingump.com	212.872.7457	New York
James A. Deeken	jdeeken@akingump.com	214.969.4788	Dallas
Patrick J. Dooley	pdooley@akingump.com	212.872.1080	New York
Christopher M. Gorman-Evans	cgorman-evans@akingump.com	44.20.7012.9656	London
Barry Y. Greenberg	bgreenberg@akingump.com	214.969.2707	Dallas
Robert M. Griffin Jr.	bgriffin@akingump.com	44.20.7012.9676	London
Leon B. Hirth	lhirth@akingump.com	212.872.1059	New York
Ira P. Kustin	ikustin@akingump.com	212.872.1021	New York
Arina Lekhel	alekhel@akingump.com	212.872.8018	New York
Burke A. McDavid	bmcdavid@akingump.com	212.872.1083	New York
Prakash H. Mehta	pmehta@akingump.com	202.887.4248	Washington, D.C.
Lisa A. Peterson	lpeterson@akingump.com	817.886.5070	Dallas
Eliot D. Raffkind	eraffkind@akingump.com	214.969.4667	Dallas
Fadi G. Samman	fsamman@akingump.com	202.887.4317	Washington, D.C.
William L. Sturman	wsturman@akingump.com	212.872.1035	New York
Ann E. Tadajweski	atadajweski@akingump.com	212.872.1087	New York
Simon Thomas	swthomas@akingump.com	44.20.7012.9627	London
Stephen M. Vine	svine@akingump.com	212.872.1030	New York