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Client Alert

A report for clients and friends of the Firm

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EU Commission Publishes Draft Proposal for Regulating Alternative Investment Fund Managers

Pressure for regulation of managers of alternative investment funds on a pan-European basis has been increasing since a review prompted in early 2008 by two European Parliamentary reports raised concerns over hedge fund and private equity activity. In response, the European Commission recently published its draft proposed directive (the "Directive") on Alternative Investment Fund Managers ("AIFM"). The Directive will apply to any AIFM established in an EU Member State which provides management or administration services to one or more alternative investment funds ("AIF"), introducing harmonised requirements for AIFM. AIF are defined as all funds that are not regulated under the UCITS Directive. Hedge funds and private equity funds will constitute the majority of AIF; real estate, commodity and infrastructure funds will also be AIF. AIFM managing AIF portfolios with total assets of less than €100 million will be exempt. In a concession to private equity, AIFM managing AIF portfolios of less than €500 million which are not leveraged and with no redemption rights exercisable for five years following launch will also be exempt. Most importantly for U.S. managers, the Directive also creates an authorisation requirement for AIFM wherever based who wish to market AIF in the EU.

The draft legislation has been criticised by many in the industry. For private equity, the European Venture Capital Association said of the Directive, "The Commission's proposals hit the wrong people, at the wrong time, in the wrong way" and Simon Walker, CEO of the British Venture Capital Association, commented "There is no rationale for the Commission to intervene against private equity. Yet, if this directive were to become law, it would have a dramatic and damaging impact on the industry." For hedge fund managers, the Alternative Investment Management Association responded that the Directive was "not a proportionate regulatory response to any of the identified causes of the current crisis."

Overview

The Directive, in the eyes of the Commission, seeks to:

- ensure that no significant AIFM escapes effective regulation and oversight;
- subject key service providers, including depositaries and administrators, to robust regulatory standards;
- enhance the transparency of AIFM and the funds they manage towards supervisors, investors and other key stakeholders;
- permit AIFM to market AIF to professional investors throughout the EU; and
- grant access to the European market to third country funds after a transitional period of three years.

Requirement for Authorisation

AIFM covered by the Directive may only provide management services to an AIF or market its shares once they are authorised. Entities not authorised or, in the case of AIFM not covered by the Directive, regulated under its national law, will not be allowed to provide management services to an AIF or market its shares within the EU. Non-EU AIFM are covered and provision is made for member states to authorise AIFM who do not have a registered office in the EU.

Marketing Passport

Once authorised, an AIFM would be permitted to promote AIF that it manages to "professional investors" throughout the EU. This will create a consistent EU private placement regime but some AIF investors may struggle to qualify as "professional investors". Member states may individually permit an AIFM to promote an AIF to retail investors in limited circumstances. However, AIFM may only market shares in a non-EU or "third country" AIF to professional investors domiciled in a Member State if the third country has signed an agreement with that Member State to share information on tax matters complying with OECD standards. Most hedge funds and many private equity funds are non-EU domiciled and many do not comply with OECD standards. These provisions will become available three years after the rest of the Directive has commenced and until then the relevant local private placement regime would apply.

Non-EU AIFM

Non-EU AIFM will need authorisation under the Directive in order to market AIF in the EU, even under existing private placement regimes. Such AIFM could only be authorised if they demonstrate that they are subject to equivalent prudential regulation (i.e., capital requirements) and supervision, that the AIFM's country of incorporation has entered into co-operation agreements with the Member State as to the exchange of tax and supervisory information and allows similar access for EU AIFM to its markets. U.S. AIFM are not currently subject to any prudential regulation and therefore would not be able to get authorised to market AIF unless they incorporate themselves in the EU and become authorised. If US hedge fund managers are effectively forced to establish a place of business in the EU as an authorised AIFM, they will also have to adjust their prime brokerage arrangements to fit the Directive.

These provisions will also become available three years after the rest of the Directive. In the meantime it seems non-EU AIFM would be prohibited from marketing AIF in the EU even under the existing domestic private placement rules of those states and would only be able to market AIF in the EU if they incorporate in the EU and become authorised.

The EC believes that offshore financial centres will have a strong incentive to deliver the necessary improvements to their systems of regulation during the three year time period.

Organisation and Capital Requirements

An AIFM will be required to provide its regulator with information about (i) the detailed characteristics of the AIF it manages, (ii) the identity of any investor with interests of 10% or more in those AIF, and (iii) the way in which it proposes to comply with the on-going requirements of the Directive.

AIFM will be required to have capital of at least €125,000 plus 0.2% of all assets under management in excess of €250 million. This is likely to represent a significant increase for existing AIFM in particular UK based private equity managers whose current capital requirement may be as low as £5,000.

AIFM must ensure that an independent depository (which must be an EU incorporated bank or, in the case of AIF incorporated outside the EU, an EU bank or a depository located in the fund's country of incorporation provided that stringent equivalence conditions are met) and valuator (responsible for valuing the assets or establishing the value of the shares or units of an AIF and which, where incorporated outside the EU, must apply valuation standards that the Commission has ruled equivalent to European standards) are appointed by each AIF that they manage.

Disclosure

Each AIFM must make available to its regulator and to each investor in the relevant AIF, an annual report, to include a balance sheet, profit and loss account and activity summary. The annual report must be made available within four months of the AIF financial year end and it must be audited. The following additional disclosure requirements may also apply:

(a) Controlling interest disclosure requirements - an AIFM which can exercise through its AIF 30% or more of the voting rights of an EU issuer or large EU non-listed company (which meet threshold size tests) must disclose information to the company, all its shareholders and employee representatives about their intentions regarding the future development of the business and other planned changes for the controlled entity; and

(b) Leverage disclosure requirements - where leverage exceeds the value of equity capital in two of the past four quarters, an AIFM would be required to disclose the identity of its five largest sources of leverage to the regulators and the following information to investors:

- the maximum level of leverage that the AIFM can employ on behalf of the AIF it manages;
- any right of re-use of any collateral or guarantee granted under the leveraging arrangement; and
- on a quarterly basis, the total amount of leverage actually employed by each AIF in the preceding quarter.

Delegation

AIFM will need prior permission from their regulator to delegate any of their functions. AIFM may only delegate portfolio management or risk management to a third party itself authorised as an AIFM.

What happens next?

The Directive is now up for debate with the European Parliament and the European Council where to use the Commission's own words "it is expected to be the object of intense political discussion and negotiation". The Commission hopes the Directive can be adopted by the end of 2009. Should that happen, Member States will have to implement it by the end of 2011, which means it will be 2014 before any third country AIFM and/or AIF could benefit from the new passporting regime.

We will monitor the progress of the proposed Directive.

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Proskauer's Private Investment Funds Group comprises more than 100 lawyers and advises clients worldwide on all of the legal and business issues important to private equity and hedge funds and their managers, including structuring investment vehicles of all types, portfolio company investments, institutional investor representation and secondary purchases and sales.

Please feel free to call any of the Proskauer lawyers listed below at any time if you have additional questions, or if we can be of additional assistance with the issues raised in this alert.

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