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US Venture Capital, Private Equity and Hedge Fund Managers May Face Restrictions on Marketing to EU Investors Under Proposed AIFM Directive

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Background

What is the proposed AIFM Directive?

The AIFM Directive is a proposal by the European Commission to harmonize the regulation and supervision of "alternative investment fund managers" (AIFMs) within the European Union.

An approved directive of the European Commission is required to be implemented under the laws of each member state of the European Union.

Why is it being proposed now?

Similar to the US proposals to require private investment fund managers to register as investment advisers in the wake of the Madoff affair and the credit crunch, regulatory authorities worldwide are scrutinizing participants in financial markets.

The stated purpose of the proposed AIFM Directive is to provide a harmonized regulatory standard for AIFMs and increased transparency of the activities of AIFMs and the funds (AIFs) they manage for investors, public authorities and other stakeholders.

While questions have arisen as to whether the proposed AIFM Directive is an appropriate or proportionate response, its stated intent is to ensure the proper functioning of the financial markets (especially in connection with systemic risk) and to overcome gaps and inconsistencies in existing regulatory frameworks of the European Union member states with respect to AIFMs.

As a US fund manager, why do I care about the proposed AIFM Directive?

The proposed AIFM Directive would prohibit or limit the ability of non-EU fund managers – including US fund managers – to market interests in their funds to EU investors.

At a minimum, the AIFM Directive proposals would require full or partial compliance by US fund managers with the AIFM Directive in order to market interests to EU investors. It is possible, however, that even compliance with the AIFM Directive would not be sufficient to permit access to EU investors unless the US government were to agree to cooperate with EU and/or enforce the AIFM Directive.

See below for more detail.

What is the status of the proposed AIFM Directive?

The European Commission first proposed the AIFM Directive in April 2009. Since then, the draft has been subject to numerous revisions, amendments and compromise proposals. The European Parliament and European Council approved their versions of the proposal on May 17 and 18, respectively.

The Commission, Parliament and Council are now engaged in a "trilogue" negotiation process to reconcile the different proposals.

It is anticipated that a compromise draft will be voted on by the Parliament in July 2010. Recent press reports, however, indicate that this vote may be pushed back to Autumn 2010 or early 2011.

If it passes at that time, one proposal indicates that it would need to be implemented by the EU member states within 24 months.

What is the US government doing in response?

Treasury Secretary Geithner has written to the European Commissioner for Internal Markets and Services voicing concern over the proposed AIFM Directive and its potential discriminatory effect on US fund managers.

There has been much discussion over the possibility that the US regulators will retaliate against European fund managers by requiring similar regulation in connection with accessing the US market. While this possibility exists, the effect may be mitigated by (1) the likelihood that any US regulation would be lighter than that imposed by the AIFM Directive and (2) US investors protesting more strongly against prohibitions on their access to investments in EU AIFs.

What can US fund managers do now?

As will be evident from the details below, the provisions of the proposed AIFM Directive are in flux and subject to continued revision based on the varying proposals of the Commission, Council and Parliament. Until we have a more definitive proposal, there is little planning that can be done.

If, however, you are planning to raise a fund and solicit EU investor capital, it will be important to stay informed of the status of the AIFM Directive proposals.

We will continue to update you as more definitive rules are finalized.

Scope

Who is covered by the proposed AIFM Directive?

In general, the proposed AIFM Directive would directly regulate AIFMs who manage AIFs and therefore would indirectly regulate certain matters concerning the operation and constitution of an AIF.

The term “AIF” covers “collective investment undertakings” that are not already regulated by the EU under the UCITS regime (UCITS funds are similar to US mutual funds). This would include hedge funds, private equity funds, venture capital funds, real estate funds and other closed-ended funds.

The proposed AIFM Directive would also regulate the marketing of AIFs within the EU by AIFMs. As a result, it would apply to non-EU fund managers, including US fund managers, that market interests to EU investors.

What does “marketing” mean?

"Marketing" generally means an offering or placement of interests in an AIF to EU investors. In the Commission's draft, it does not matter at whose initiative the offer or placement takes place, so "passive" marketing would be prohibited.

The Council's and Parliament's proposals both specify that such an offer or placement is only prohibited if taken at the initiative of the AIFM or on its behalf.

While this limits the prohibition to "active" marketing, the Parliament's proposal would prohibit the end result of passive marketing in a different way. Under that proposal, EU professional investors would be prohibited from investing in interests in a non-EU AIF if the requirements of the proposed AIFM Directive are not met.

See below for more detail.

How does the proposed AIFM Directive apply to non-EU AIFMs, such as US fund managers?

The three proposals address this in different ways. Each proposal could significantly restrict the ability of US fund managers to market interests in their funds to EU investors. It should be noted that US fund managers that operate funds organized in any jurisdiction – whether the US, Cayman Islands or otherwise – would be affected in a similar manner.

Commission Proposal:

- EU member states may allow non-EU AIFMs to market AIFs to professional investors in the EU provided that the non-EU jurisdiction (1) has legislation "equivalent" to the AIFM Directive, (2) grants reciprocal access to marketing of EU funds, (3) has appropriate cooperation arrangements with the competent authorities of the EU member state and (4) has agreements in place regarding exchange of tax information under an OECD model tax treaty.
- Non-EU AIFMs would also have to comply with certain disclosure requirements.
- Would provide for an EU-wide "passport" for marketing to investors – but only if the required agreements between the non-EU jurisdiction and each EU member state are in place.
- Requires cooperation of the non-EU (*e.g.*, US) competent authorities.

Council Proposal:

- EU member states may allow non-EU AIFMs to market AIFs to professional investors in their own territory provided (1) the non-EU AIFMs comply with certain disclosure and reporting obligations including certain of those related to controlling interests in portfolio companies and (2) appropriate cooperation arrangements exist between the non-EU authorities and each of the EU member states.
- Does not provide for an EU-wide marketing "passport" but permits the national private placement regimes of EU member states to control the marketing of AIFs on a country by country basis.
- Requires cooperation of the non-EU (*e.g.*, US) competent authorities.

Parliament Proposal:

- Non-EU AIFMs would need to voluntarily subject themselves to the AIFM Directive requirements and submit to the jurisdiction of EU courts.
- The financial regulatory authorities of the non-EU jurisdiction must agree to act as agent to the EU's competent authorities in the supervision and enforcement of the AIFM.
- The non-EU jurisdiction would be required to (1) have certain standards to combat money laundering and terrorist financing, (2) grant reciprocal access to marketing of EU funds in its jurisdiction and (3) have agreements in place with the EU regarding exchange of tax and monitoring information.
- Would provide for an EU-wide "passport" for marketing to investors throughout the EU.Requires significant cooperation and enforcement by the non-EU (*e.g.*, US) financial regulatory authorities.

Are there any restrictions on EU investors themselves?

As mentioned above, the Parliament's proposal prohibits EU professional investors from investing in a non-EU AIF if the third-country provisions summarized above are not satisfied. This would, in effect, prevent "passive" marketing by AIFMs and further restrict the ability of EU investors to invest in US funds.

It is unclear whether the EU will pursue this path which would prevent EU institutional investors from making their own investment decisions and implementing their own investment policies, rather than by regulating only the AIFMs themselves. The Commission's proposal achieves the same goal by prohibiting the non-compliant AIFMs from offering their interests to EU investors regardless of who initiates the offer.

In either case, however, it is likely that EU investors would not be subject to these prohibitions if they set up subsidiaries or affiliates outside of the EU in a jurisdiction such as the Channel Islands or Cayman Islands to make investments in non-EU AIFs.

Does the proposed AIFM Directive affect EU AIFMs who form funds outside of the EU (such as the Cayman Islands or the Channel Islands)?

Yes. Similar, but slightly different, requirements to those applicable to a non-EU AIFM described above would apply to an EU AIFM (*e.g.*, a UK manager) who markets interests in a non-EU fund (*e.g.*, a Jersey fund) to EU investors.

Content

What types of requirements does the proposed AIFM Directive impose?

The proposed AIFM Directive governs an AIFM with respect to some or all of the following, depending on the proposal:

- capital requirements
- liquidity management requirement
- remuneration policies
- independent valuator and depository requirements
- delegation of AIFM functions
- marketing and management of AIFs
- disclosure requirements
- transparency requirements for reporting to regulators and investors
- leverage restrictions and/or disclosure
- disclosure of certain portfolio company information

Disclosure of portfolio company information sounds problematic – what is required?

If an AIF managed by an AIFM acquires a controlling or significant interest in a portfolio company, certain information may have to be disclosed to certain parties. These parties may include the company, its shareholders and employees and the competent regulatory authorities.

The definition of a controlling or significant interest varies in the different proposals from 50% in the Council draft to 30% in the Commission draft and as low as 10% in certain cases under the Parliament draft.

Certain small and medium sized enterprises may be exempted, but the exemption may be dependent on the number of employees. Private equity and venture capital funds are exempted from disclosure of certain information under the Parliament's proposal.

Information that must be disclosed may include, depending on the proposal, some or all of the following: operational and strategic development plans, employee matters, significant divestment of assets, capital structure, number of employees, communications and conflicts policies, management arrangements and compensation, financial risks, environmental policy and R&D.

Other investors in the same portfolio company, such as corporate investors, are not subject to the same disclosure requirements which may result in an uneven playing field for AIFs as compared to such other investors.

Are all AIFMs treated the same with respect to the proposed AIFM Directive requirements?

Under the Commission's proposal, all types of AIFMs are subject to the same requirements.

Under the Parliament's and Council's proposals, however, there are exemptions for private equity and venture capital funds from some of the requirements that would continue to apply to hedge funds.

For instance, AIFMs managing private equity and venture capital funds would be exempt from the liquidity management, depositary, capital and certain disclosure requirements under the Parliament's proposal, whereas AIFMs managing unleveraged closed-ended AIFs would be exempt from the liquidity management requirement under the Council's proposal.

Is there an exemption from any of the requirements for small AIFMs?

The proposals exempt AIFM with cumulative assets under management of EUR 250-500 million, provided that their AIFs are unleveraged and/or without redemption rights. The variables depend on the particular proposal. Note, however, that the Parliament's proposal only exempts small AIFMs from some, but not all, of the proposed requirements.

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We look forward to keeping you updated with respect to further developments connected to the proposed AIFM Directive.

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