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Proposed EU Directive on Alternative Investment Fund Managers

The European Commission (the "Commission") has just published proposals for the more intensive regulation of European-based managers of hedge funds, private equity funds and other alternative investment funds. The proposals come in the form of a draft European Directive dated 30 April 2009 (the "Directive"),[1] which will now be sent to the European Parliament and the European Council for review and possible amendment. If approval of the Commission's proposals is reached by the end of 2009, the Directive could come into force in 2011. Due to the considerable political pressure to regulate the alternative investment fund industry at an EU level, it is likely that the Directive will be adopted in some form.

The aim of the proposed Directive is to create a regulatory framework for European Union ("EU") domiciled managers of what are referred to in the Directive as "Alternative Investment Funds", rather than to regulate the funds themselves. Alternative Investment Fund Managers ("AIFMs") within the scope of the Directive would need to be authorized by their national regulator and would be required to provide detailed information on the planned activity and characteristics of the funds they manage, their governance and their arrangements concerning risk management and the valuation and safe-keeping of assets. The manager would also be required to hold a minimum level of capital.

The Directive would impose ongoing conduct-of-business and reporting requirements. Managers would be obligated to provide certain disclosures to investors, and additional disclosure obligations would apply to managers managing leveraged funds and controlling stakes in companies. The Directive would restrict managers' ability to delegate certain functions.

Although most of the Directive will be unwelcome to fund managers, there may be some benefits from proposals to allow a fund manager regulated in one EU Member State to market its funds to professional

[1] Draft Directive dated 30 April 2009 of the European Parliament and of the Council on Alternative Investment Fund Managers.

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investors[2] across the EU and to provide management services in other EU Member States, subject to notification procedures.

Who is covered by the Directive?

It is proposed that the Directive will apply to AIFMs that:

- are established in the EU; and
- provide management services[3] to Alternative Investment Funds ("AIFs") – that is, open- or closed-end collective investment undertakings that are not regulated under the EU UCITS Directive,[4] including most commodity funds, real estate funds, infrastructure funds, hedge funds, venture capital funds and private equity funds, whether or not such funds are domiciled inside the EU.

There would be a *de minimis* exemption for AIFMs that (a) manage AIF portfolios with total assets not exceeding €100 million (including assets acquired through the use of leverage) or (b) only manage AIFs that are not leveraged, do not grant investors redemption rights during a period of five years following the date of constitution of each AIF, and have total assets under management not exceeding €500 million.

AIFMs would be prohibited from providing management services to any AIF and from marketing AIFs in the EU, without prior authorization. An AIFM that is authorized in one EU Member State would generally be able to provide management services to AIFs domiciled in other Member States, subject to notification procedures.

An authorized AIFM would have to comply with certain reporting and disclosure requirements, minimum capital requirements, conduct-of-business and other requirements. These requirements are discussed below.

Application for authorization

An AIFM applying for authorization would be required to provide certain information to its national regulator, including:

- The identities of the AIFM's owners with qualifying holdings[5] and the amounts of those holdings.

[2] "Professional investor" means any investor that is a "professional client" under the Markets in Financial Instruments Directive (MiFID)(2004/39/EC). These include, in general, (a) credit institutions, investment firms, financial institutions, insurance companies, funds and their management companies and other institutional investors that are required to be authorized or regulated to operate in the financial markets, (b) large undertakings meeting certain size requirements, (c) national and regional governments and public bodies, (d) supranational institutions and international organizations, (e) other institutional investors whose main activity is to invest in financial instruments, and (f) certain investors that can be opted up in accordance with the procedures of MiFID.

[3] "Management services" is defined in the Directive as "the activities of managing and administering one or more AIF on behalf of one or more investors."

[4] Directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). So-called UCITS funds are roughly the European equivalent of US mutual funds registered under the US Investment Company Act of 1940. Managers of UCITS funds already require authorization. The aim of the Directive is to ensure that EU-based managers of funds not regulated under the UCITS Directive also require authorization.

[5] "Qualifying holding" means any direct or indirect holding in an AIFM that represents 10% or more of the capital or of the voting rights or which makes it possible to exercise a significant influence over the management of the AIFM.

- A programme of activity.
- The characteristics of the AIFs it intends to manage, including offering memoranda and constitutional documents of each AIF.
- Any delegation of management services and arrangements for the safe-keeping of assets.
- Any information or materials that are to be provided to investors.

The Directive does not include a general requirement to disclose the identity of the investors in AIFs, except where an investor receives preferential treatment. AIFMs operating in the EU before the Directive is implemented would have a year from that date to apply to be authorized.

Minimum capital requirement

The Directive would impose a minimum capital requirement on authorized AIFMs of €125,000, plus 0.02% of any excess of assets under management over €250 million.[6]

Marketing rights under the Directive

By authorized EU AIFMs

- *EU domiciled AIFs*: Marketing of fund interests to professional investors in the EU would be permitted subject to a notification procedure.
- *Non-EU domiciled AIFs*: Three years after the implementation date of the Directive, subject to a notification procedure, marketing to professional investors in the EU would be permitted in respect of interests in AIFs domiciled in jurisdictions that meet certain conditions. These conditions include:
    - The relevant jurisdiction has to have signed an agreement with the relevant Member State that ensures effective exchange of information in tax matters.
    - The depositary of the AIF would have to be a credit institution having its registered office in the EU.
        - The depositary will only be able to delegate its functions to a depositary in the relevant non-EU jurisdiction if the regulations in that jurisdiction with respect to sub-depositaries and money laundering are deemed to be equivalent to those in the EU.

[6] In addition, the AIFM's own funds must never be less than the amount required under the EU Capital Adequacy Directive.

- If the administrator that is appointed to value the assets of the AIF is established outside the EU, the valuation standards and rules used by administrator in the relevant jurisdiction must be deemed to be equivalent to those in the EU.

By unauthorized EU AIFMs

- The marketing rights under the Directive would not apply to AIFMs exempt from the authorization requirement (by virtue of the *de minimis* provisions), unless the AIFMs opt in to the Directive.

By non-EU AIFMs

- *EU and non-EU domiciled AIFs*: Three years after the implementation date of the Directive, non-EU AIFMs would be able to apply for authorization to market AIFs to professional investors in the EU if certain conditions are met, including that:
  - The jurisdiction where the non-EU AIFM is based has regulatory standards that are deemed to be equivalent to those in the EU and which are effectively enforced.
  - The non-EU AIFM provides the relevant national regulator in the EU with the same information as would be required of an EU-based AIFM and complies with the notification procedure for marketing AIFs.
  - The relevant jurisdiction provides corresponding access to its markets for EU AIFMs.
  - There is effective co-operation with the relevant jurisdiction, including in tax matters.
- *Non-EU domiciled AIFs*: The conditions regarding the funds themselves that are applicable to EU AIFMs' marketing of non-EU funds, described above, would also need to be met where the marketing is carried out by non-EU AIFMs.

The above provisions regarding the treatment of non-EU domiciled AIFs and AIFMs are proposed to come into force three years after the Directive is implemented, during which period the Commission will assess which jurisdictions meet the equivalency conditions set by the Directive. Existing rules in individual EU Member States on the marketing of such funds would continue to apply until then. Also, it will be left to the individual Member States to decide whether or not AIFs can in addition be marketed and sold to retail investors.

<u>Conduct of business and other ongoing requirements</u>

- *Conflicts of interest*. The Directive includes rules on conflicts of interest. Not only would authorized AIFMs be required to take reasonable steps to identify and (where arrangements made by the AIFM are not sufficient to ensure that risks of damage to investors' interests will be

prevented) disclose conflicts of interests, but also to take reasonable steps designed to *prevent* conflicts of interests from adversely affecting the interests of the AIF and its investors.

- *Preferential treatment of investors*. According to the Directive, no investor may obtain a preferential treatment, unless this is disclosed in the AIF's offering memorandum or constitutional documents along with the identity of the relevant investor.

- *Risk management*. Authorized AIFMs would be required to implement risk management systems in order to measure and monitor appropriately all risks associated with each AIF's investment strategy and to which each AIF is or can be exposed. Specifically, the AIFM is to ensure that the functions of risk management and portfolio management are separated and subject to separate reviews.

- *Liquidity management*. Authorized AIFMs would be required to employ an appropriate liquidity management system for each AIF, including performing regular stress tests and monitoring the liquidity risk of each AIF.

- *Depositary and valuation functions*. For each AIF it manages, an authorized AIFM would have to appoint:

    - An administrator to value the AIF's assets.

    - A credit institution having its registered office in the EU as depositary.

        - The Directive would specifically allow depositaries to delegate their tasks to other depositaries, subject to certain conditions for non-EU sub-depositaries.

<u>Delegation of AIFM functions</u>

Authorized AIFMs' ability to delegate their functions would be restricted.

- An authorized AIFM would only be able to delegate the portfolio and risk management functions to a third party that is also authorized as an AIFM to manage an AIF of the same type.

- An authorized AIFM would not be able to delegate its functions to such an extent that, in essence, it could no longer be considered the manager of the AIF.

- An authorized AIFM would not be able to delegate its functions to the depositary, the administrator, or to any other undertaking whose interests may conflict with those of the AIF or its investors.

- Delegates of an authorized AIFM would not be able to sub-delegate any of the functions delegated to them (except for depositaries as described above).

- Any delegation would require the pre-approval of the national regulator.

Investor disclosure requirements

Authorized AIFMs would be required to make available to investors an annual audited report for each of the AIFs they manage within four months of the end of the AIF's financial year.

In addition to information that would already typically be included in a private placement or offering memorandum of an AIF, authorized AIFMs would, for example, have to disclose to prospective investors:

- The circumstances in which the AIF may use leverage, the types and sources of leverage permitted and their associated risks, and any restrictions on the use of leverage.
- A description of the procedures by which the AIF may change its investment strategy or investment policy.
- A description of the AIF's valuation procedure and of the pricing models for valuing assets, including the methods used in valuing hard-to-value assets.
- A description of the AIF's liquidity risk management, including redemption rights and limitations, and how the AIFM ensures a fair treatment of investors.
- Whenever an investor obtains a preferential treatment or the right to obtain preferential treatment, the identity of the investor and a description of that preferential treatment.

Authorized AIFMs would also be required to disclose on a periodic basis to their investors:

- The percentage of the AIF's assets subject to special arrangements arising from their illiquid nature (such as side pockets).
- Any new arrangements for managing the liquidity of the AIF.
- The current risk profile of the AIF and the risk management systems employed by the AIFM to manage these risks.

The Commission would adopt implementing measures further specifying the disclosure obligations and their frequency.

Reporting obligations to regulators

An authorized AIFM would be required to provide to its national regulator information on the main instruments in which it is trading, the markets of which it is a member or in which it actively trades, and on the principal exposures and the most important considerations of each of the AIFs it manages.

Authorized AIFMs would have to periodically provide the following information to the relevant national regulator:

- The percentage of the AIF's assets that are subject to special arrangements arising from their illiquid nature (such as side pockets).
- Any new arrangements for managing the liquidity of the AIF.
- The actual risk profile of the AIF and the risk management tools employed by the AIFM to manage those risks.
- The main categories of assets in which the AIF invested.
- Where relevant, the use of short selling during the reporting period.
- Annual reports of each AIF within four months of the end of the period to which they relate.
- A detailed list of AIFs that the AIFM manages for the end of each quarter.

The Commission would adopt implementing measures further specifying the disclosure obligations and their frequency.

Specific rules regarding leveraged AIFs

Authorized AIFMs would have to assess on a quarterly basis whether any AIF employs "high levels of leverage on a systematic basis" and inform the national regulator accordingly.[7]

In respect of each such leveraged AIF, authorized AIFMs would have to:

- Disclose to investors the maximum level of leverage that the AIFM may employ on behalf of the AIF and any right of counterparties of the AIF to re-use the collateral or guarantee posted under the leveraging arrangement.
- On a quarterly basis disclose to investors the total amount of leverage employed by each AIF in the preceding quarter.

In addition, authorized AIFMs would have to regularly provide the national regulator with information about the level of leverage employed by each applicable AIF, including leverage embedded in financial derivatives.

[7] An AIF would be deemed to employ high levels of leverage on a systematic basis where the combined leverage from all sources exceeds the value of the equity capital of the AIF in two out of the past four quarters. Leverage includes any method by which the AIFM increases the exposure of an AIF to a particular investment whether through borrowing of cash or securities, through leverage embedded in derivative positions, or by any other means.

Potential limits on leverage

The Directive provides that, in order to ensure the stability and integrity of the financial system, the Commission shall set limits on the level of leverage authorized AIFMs can employ in their AIFs. The limits should take into account, *inter alia*, the type of AIF, its strategy and the sources of its leverage. Regulators would also be able to impose additional, temporary limits on leverage in exceptional circumstances.

Specific rules applicable to managers that acquire controlling influence in companies

Where an authorized AIFM is in a position to exercise controlling influence[8] in certain non-listed companies domiciled in the EU,[9] the AIFM would be required to provide the company and all other shareholders with certain information, including:

- The resulting situation in terms of voting rights.
- The conditions under which controlling influence was reached, including information about the identity of the different shareholders involved.
- The date on which the threshold was reached.

In addition, an authorized AIFM with controlling influence in such a non-listed company, or an EU listed company,[10] would have to disclose certain information to the company, its shareholders and employees, including:

- The policy for preventing and managing conflicts of interests, in particular between the AIFM and the company.
- The company's policy for external and internal communication, in particular as regards employees.
- The AIFM's plans with respect to the company.

The annual reports of AIFs that exercise controlling influence in a portfolio company would also have to include certain information about the portfolio company.[11]

[8] Controlling influence is described as 30% or more of the voting rights of a company. The positions held in the company by all AIFs managed by an AIFM should be included for purposes of the 30% calculation. Also, the positions held in the company by one or more other AIFMs acting in concert by "agreement" should be combined for this purpose.

[9] There is a *de minimis* exception for small and medium sized enterprises that employ fewer than 250 persons, have annual revenues not exceeding €50 million and/or an annual balance sheet not exceeding €43 million.

[10] Subject to the same *de minimis* exception that applies to non-listed companies, an EU listed company for this purpose would be a company whose securities are admitted to trading on a "regulated market" within the European Economic Area. The Commission maintains a list of regulated markets within the EEA.

[11] This information includes information about the capital structure, including: financial risks associated with it; employee turnover, terminations and recruitment; significant divestments; and corporate governance.

Post-delisting reporting requirements for portfolio companies

If an AIF delists a portfolio company's shares from a regulated market as a result of buying a controlling influence in it, the company would be obliged to continue to comply with its pre-delisting disclosure obligations for two years following the delisting.

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