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Draft European Directive on Alternative Investment Fund Managers

The first draft of a proposed EU Directive on Alternative Investment Fund Managers, currently being considered by the European Commission and due to be released on April 29, 2009, has been widely leaked. Given the significance of the changes in contemplation, which will affect all EU managers of hedge and private equity funds, we outline in this memorandum some of the key provisions of the draft and attach a link to the text for those wishing to keep abreast of this important topic as the proposals unfold.

Background

Pressure for regulation of managers of alternative investment funds on a pan-European basis has been steadily increasing in recent months. The proposed Directive on Alternative Investment Fund Managers¹ (the "Draft Directive") was originally due to be published on April 21, 2009 but has now been delayed. At the time of writing, it is due to be published on April 29, 2009.

The explanatory memorandum to the Draft Directive states that the proposals stem from concerns about the adequacy of the regulatory and supervisory frameworks of financial markets in the wake of the financial crisis, in particular the perceived lack of oversight and supervision of the activities of managers of investment funds.

Key Proposals

- **The Draft Directive applies only to fund managers located in the EU:** Managers will

require authorization from regulators in order to manage and market funds within the EU.²

- **Alternative investment funds:** The Draft Directive applies to managers of "alternative investment funds": that is, funds (including hedge funds and private equity funds located anywhere in the world) that are not regulated under the UCITS Directive.³
- **De minimis exemption:** The Draft Directive will apply only to fund managers who are managing funds with more than €250 million of assets under management.⁴
- **EU fund managers must be authorized:** Managers will be required to obtain authorization from the competent authority of their home State to manage a fund from the EU.⁵ Managers may be authorized to provide management services either for all types of fund or only for specific types.⁶
- **Authorized EU fund managers can market funds across the EU to "professional**

¹ Text available at http://www.euractiv.com/29/images/draft%20hedge%20funds_tcm29-181468.doc

² Draft Directive, Article 4

³ Directive 1985/611/EEC

⁴ Draft Directive, Article 3(1)

⁵ Draft Directive, Article 25(1)

⁶ Draft Directive, Article 25(2)

investors⁷: In addition, Member States would be able to decide on an individual basis whether to allow managers to market funds to retail investors.⁸

- **Operating conditions:** In order to become authorized, managers will need to demonstrate that they are suitably qualified and satisfy the competent authority as to the risk management arrangements in respect of liquidity, operational and counterparty risk, the management and disclosure of conflicts of interest, the fair valuation of assets and the security of depository and custodial arrangements.⁹
- **Requirement to provide home state regulator with detailed information relating to funds managed:** Information to be supplied includes the planned activity, identity and characteristics of funds (including the identities of fund members and the instruments of incorporation and fund rules), governance mechanisms, arrangements for the valuation and safe-keeping of assets, audit arrangements and regulatory reporting systems.¹⁰
- **Minimum capital requirements for authorized fund managers:** Managers will be required to hold and retain a minimum level of capital of at least €125,000, plus 0.02% of the amount by which the value of the manager's portfolios exceeds €250 million.¹¹
- **Pre-investment and ongoing disclosure and reporting obligations for authorized managers:** Investors must be provided with a description of the fund's objectives and investment strategy, including assets in which the fund may invest, the investment techniques that may be employed, details of the circumstances in which leverage may be used, the types and sources

of leverage permitted and any risks or restrictions associated. Investors must also be provided with a description of the procedures by which the fund may change its investment strategy or policy and a description of all fees, charges and expenses which are directly or indirectly borne by investors, including the maximum amounts of any such expenses.¹²

- **Additional disclosure obligations for managers engaging in high levels of leverage:** Managers must disclose to both regulators and investors information including the maximum level of leverage that will usually be employed and, on a regular basis, the total amount of leverage actually employed by the fund.¹³ These additional requirements only apply in respect of funds with more than €500 million of assets under management and where the amount of leverage employed exceeds the value of the fund's equity capital.¹⁴
- **Additional disclosure obligations for managers holding a controlling influence in non-listed companies:** Where managers are in a position to exercise 30% or more of the voting rights of an issuer or non-listed company they will be required to notify the company and its shareholders of that control and provide information including: the resulting situation in terms of voting rights, the conditions under which the 30% threshold has been reached and the date on which it was reached.¹⁵ These additional requirements do not apply where the issuer or non-listed company employs fewer than 250 persons, has an annual turnover not exceeding €50 million and/or an annual balance sheet total not exceeding €43 million.¹⁶

⁷ Draft Directive, Article 30(1). "Professional Investors" has the meaning set out in the Markets in Financial Instruments Directive (Directive 2004/39/EC)

⁸ Draft Directive, Article 30(2)

⁹ Draft Directive, Article 26(1)(g)

¹⁰ Draft Directive, Article 26(1)

¹¹ Draft Directive, Article 5

¹² Draft Directive Article 15

¹³ Draft Directive, Article 18

¹⁴ Draft Directive, Article 17

¹⁵ Draft Directive, Article 21

¹⁶ Draft Directive, Article 22(2)

Commentary

A number of high-profile European politicians have been critical of the Draft Directive in recent days. In a letter¹⁷ to José Manuel Barroso, President of the

European Commission, European Socialist leaders claimed that the Draft Directive is "filled with loopholes", arguing in particular that:

- Funds themselves should be regulated;
- There should be no de-minimis exemption;
- The Draft Directive would allow non-EU funds managers to market their funds in the EU without complying with regulatory requirements;
- Funds should be required to meet a liquidity requirement coupled with a leverage ratio;
- The disclosure obligations in the Draft Directive are insufficient – ongoing flows of information to regulators and supervisors being essential to assess the stability of the financial system;

¹⁷ Text available at

http://www.euractiv.com/29/images/Letter%20to%20Barroso%2020%20April%2009_tcm29-181469.doc

- The Commission should address the issue of taxation of investors;
- Potential market disruption behavior by non-EU funds buying and selling European financial assets and companies should be addressed;
- The Draft Directive should contain a provision ensuring that institutional investors such as banks, insurance companies and pension funds only be allowed to invest in funds complying with the Draft Directive; and
- The regulation of naked short selling needs to be addressed within the new regulatory framework.

The letter said that "it would be a major political mistake were the Commission to adopt [the current draft] proposal". It has been reported¹⁸ that Poul Rasmussen, one of the authors of the letter, said he had seen no signs of wholesale changes by the Commission.

¹⁸ "EU draft rules for hedge funds attacked" Financial Times, April 20, 2009, available at <http://www.ft.com/cms/s/0/ce034548-2df7-11de-9eba-00144feabdc0.html>

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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