

Asset Management, Financial Institutions Advisory, Financial Regulatory | May 1, 2009

## New European Proposals for the Regulation of Alternative Investment Fund Managers

After much media comment and a great deal of speculation about behind-the-scenes political wrangling, the European Commission has finally published its proposed Directive on Alternative Investment Fund Managers (the “Proposed Directive”). The Proposed Directive contemplates significant changes in regulation that will affect all EU managers of the larger hedge and private equity funds (amongst others). The proposal will now be considered by the European Parliament and Council, where it is expected to be heavily debated. In this memorandum we highlight the key provisions of the Proposed Directive and examine some of the commentary the proposal has attracted since its official publication.

### Background

The first draft of the Proposed Directive on Alternative Investment Fund Managers<sup>1</sup> was widely leaked in early April 2009.<sup>2</sup> Following substantial media comment on the contents of the leaked draft, the publication of the Proposed Directive was delayed from April 21, 2009, to April 29, 2009. The official text of the Proposed Directive itself was only made available on April 30, 2009.

The Proposed Directive, like the earlier leaked draft, focuses its regulatory efforts on managers of funds rather than the funds themselves.

### Key Proposals

- **Compulsory authorization of fund managers located in the EU:** Managers located in the EU will require authorization from regulators in order to manage and market funds.<sup>3</sup> Once authorized, managers will be able to market EU funds across Europe to ‘professional investors’ (see below). Managers may be authorized to provide management services either for all types of fund or only for specific types.<sup>4</sup>
- **Fund managers located outside the EU may, in theory, be able to apply for a recognized status enabling them to market funds across Europe:** Three years after the rest of the Proposed Directive comes into force, Managers located outside of the EU may be able take advantage of the pan-European marketing passport described below, provided that the third country in which the manager is located (i) meets certain equivalent regulatory and information-sharing standards and (ii) offers equivalent access

<sup>1</sup> Text available, along with press release and frequently asked questions, at [http://ec.europa.eu/internal\\_market/investment/alternative\\_investments\\_en.htm](http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm).

<sup>2</sup> Shearman & Sterling LLP Client Publication Draft European Directive on Alternative Investment Fund Managers, text available at <http://www.shearman.com/files/Publication/6c6a4956-2e80-46ff-862b-dd6c5da8d089/Presentation/PublicationAttachment/74375bdf-2f2f-4e09-bfb7-673ac902fac9/AM-042209-Draft-Euopean-Directive-on-Alternative-Investment-Fund-Managers.pdf>.

<sup>3</sup> Proposed Directive, Article 4.

<sup>4</sup> Proposed Directive, Article 4(2).

to its markets for EU-based managers.<sup>5</sup> How likely it is that other jurisdictions will offer the required equivalent access to markets remains to be seen. It appears that failure to offer that equivalent access may result in non-EU managers being unable to market their funds in Europe at all.

- **Alternative investment funds:** The Proposed 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 required to be regulated under the UCITS Directive.<sup>6</sup> UCITS funds are, essentially, European-regulated retail funds which can be freely marketed across Europe to retail and other investors.
- **De minimis exemptions:** The Proposed Directive does not apply to managers of small funds. For this purpose, different thresholds are effectively applied to private equity funds and hedge funds. Generally, the Proposed Directive applies to fund managers who are managing funds with more than €100 million of assets under management. However, there is a further exemption - mostly benefiting to private equity fund managers - for those managing funds with less than €500 million of assets under management, which do not use leverage and which lock investors in for at least five years.<sup>7</sup> This differs from the leaked draft, which had proposed a blanket €250 million threshold for all types of fund (including both private equity and hedge funds).
- **Once authorized, managers can market EU domiciled funds to "professional investors":**<sup>8</sup> In addition, Member States would be able to decide on an individual basis whether to

allow managers to market such funds to retail investors.<sup>9</sup>

- **Marketing of offshore funds by authorized managers:**<sup>10</sup> Authorized managers will also be able to market offshore funds to "professional investors" (but, unlike for EU-based funds, apparently not to retail investors even if Member States wish to allow this). However, this will only be possible (i) three years after the rest of the Proposed Directive has come into force and (ii) if the jurisdiction in which the offshore fund is based has entered into an agreement with the relevant Member State where the investors are located which complies with the OECD Model Tax Convention (i.e. the exchange of tax information between authorities).

In the meantime, offshore funds can continue to be marketed in Member States to the extent currently permitted. This varies from country to country.

- **Authorization conditions:** In order to become authorized, managers will need to demonstrate that they are suitably qualified and have various risk management arrangements in place. Managers will be subject to general requirements to act honestly, fairly and with due skill, care and diligence. As well as acting in the best interests of its funds and investors in those funds, managers will also be expected to act in the best interests of the "integrity of the market", although there is no suggestion as to what that means.<sup>11</sup>
- **Information about funds to be provided as part of the authorization process:** Information to be supplied prior to authorization includes the planned activity, location and characteristics of the funds to be managed (including the identities of fund shareholders, the amounts held by any shareholder holding 10% or more of the capital and the instruments of incorporation and fund rules), governance

<sup>5</sup> Proposed Directive, Articles 39 and 54.

<sup>6</sup> Proposed Directive, Articles 2 and 3. Directive 1985/611/EEC. The recast UCITS Directive, referred to in the Proposed Directive as "Directive 2009/.../EC", is expected to be adopted later this year.

<sup>7</sup> Proposed Directive, Article 2(2).

<sup>8</sup> Proposed Directive, Article 2(1). "Professional Investors" has the meaning set out in the Markets in Financial Instruments Directive (Directive 2004/39/EC).

<sup>9</sup> Proposed Directive, Article 32.

<sup>10</sup> Proposed Directive, Article 32.

<sup>11</sup> Proposed Directive, Articles 9 -13.

mechanisms and arrangements for delegation and safe-keeping of assets.<sup>12</sup>

- **Service providers and delegation:** The Proposed Directive seeks to ensure that key service providers, such as depositories, are also subject to appropriate regulation.<sup>13</sup> Independent valuers (termed “valuators”) of fund assets must be appointed. Any delegation of functions by the manager is subject to prior authorization by the regulator where the fund manager is incorporated. In addition, a manager’s liability will not be affected by the fact that it has delegated functions to a third party.<sup>14</sup>
- **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.<sup>15</sup>
- **Pre-investment and ongoing disclosures to investors:** Investors must be provided with a wealth of information (some of which will already be provided by managers in offering documentation as a matter of course), including a description of the fund’s objectives and investment strategy, assets in which the fund may invest, investment restrictions, details of the circumstances in which leverage may be used, the types and sources of leverage permitted and any associated risks or restrictions. Investors must also be provided with a description of the procedures by which the fund may change its investment strategy or policy, details of any delegation and of any service providers, a description of all fees, charges and expenses borne by investors, including the maximum amounts of any such expenses. Of particular interest to hedge funds that have previously entered into side-letter agreements with certain investors is that the identity of any investor receiving preferential

treatment – and details of that preferential treatment – must be disclosed to other investors.<sup>16</sup>

- **Ongoing reporting obligations to regulatory authorities:** Information to be reported includes (i) the main markets and instruments in which the manager trades, (ii) the principal exposures of the manager’s funds, (iii) the percentage of any fund’s assets that are illiquid, (iv) the main categories of assets in which any fund is invested and (v) their use of short selling.<sup>17</sup>
- **Additional disclosure obligations for managers engaging in high levels of leverage (and limits on leverage):** The additional disclosure obligations only apply where the amount of leverage employed exceeds the value of the fund’s equity capital.<sup>18</sup> These obligations are therefore likely to be most relevant for hedge fund managers. Managers must disclose both to regulators and investors the maximum level of leverage that will usually be employed and, on a quarterly basis, the total amount of leverage actually employed by the fund.<sup>19</sup>

Although limits on leverage are not contained in the Proposed Directive, it is stated that rules will be introduced that limit the leverage which managers may employ, depending on the nature of the underlying fund.<sup>20</sup> Hedge fund managers, in particular, will need to closely monitor developments on this issue.
- **Additional disclosure and other obligations for managers holding a controlling influence in larger issuers or non-listed companies:** These additional obligations are likely to be of most relevance for private equity funds. Where a manager is in a position to exercise 30% or more of the voting rights of an issuer (essentially, a listed company)

<sup>12</sup> Proposed Directive, Article 5.

<sup>13</sup> Proposed Directive, Article 17.

<sup>14</sup> Proposed Directive, Article 18.

<sup>15</sup> Proposed Directive, Article 14.

<sup>16</sup> Proposed Directive, Article 20.

<sup>17</sup> Proposed Directive, Article 21.

<sup>18</sup> Proposed Directive, Article 22.

<sup>19</sup> Proposed Directive, Article 23.

<sup>20</sup> Proposed Directive, Article 25.

or non-listed company domiciled in the EU, the manager will be required to (i) notify the company and its shareholders of this and (ii) provide them all with related 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.<sup>21</sup> 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.<sup>22</sup>

Shareholders of such an issuer or non-listed company, and its employees (or their representatives), must also be provided by the manager with, among other things, a development plan for the company and a policy for communicating with employees.<sup>23</sup>

- **Other "third country" provisions (only applicable three years after the rest of the Proposed Directive comes into force):** The Proposed Directive contains additional requirements for managers wishing to appoint administrators or valuers of fund assets domiciled outside the EU (in a "third country"). The administrator or valuer must meet the requirements applicable to all EU administrators and valuers. Furthermore, the third country must have regulatory/valuation standards that are broadly equivalent to those in the EU. EU depositaries wishing to delegate to non-EU sub-depositaries located in the same jurisdiction as the fund itself may do so, provided those sub-depositaries are regulated to EU-equivalent standards. It is also worth noting that any depositary that delegates to a sub-depositary located in a third country - which in some jurisdictions may well be required in order to hold

securities there – will remain liable to investors, despite the delegation.<sup>24</sup>

## Commentary

A number of high-profile European politicians including Poul Rasmussen were initially extremely critical of the leaked draft of the Proposed Directive on the basis that it did not go far enough, arguing that "it would be a major political mistake were the Commission to adopt [the draft] proposal".<sup>25</sup>

By contrast, industry bodies AIMA and BVCA both issued statements after the leak of the draft that criticized in particular the short timescale within which the draft had been produced, the lack of consultation with the industry and the apparent political motivations behind it, as opposed to sound economic underpinnings. Florence Lombard, AIMA's chief executive, identified the large volume of political rhetoric underlying the draft directive which appeared "designed to satisfy domestic audiences ahead of the forthcoming European elections rather than to secure an effective and sensible solution to identified problems".<sup>26</sup> This political rhetoric is particularly baffling. Lombard reasoned, in light of the fact that "all the major reports into the current crisis, including the de Larosiere report and the Turner Review, concluded that hedge funds played an absolutely peripheral role."

Lombard has further criticized the failure of the Commission to deliver a proportionate regulatory response to the identified causes of the current crisis. The Proposed Directive contains many "ill-considered provisions which are impractical and may prove unworkable. The unintended consequences of these measures put thousands of jobs in several major

<sup>24</sup> Proposed Directive, Article 38.

<sup>25</sup> In a letter to the European Commission President; Text available at [http://www.euractiv.com/29/images/Letter%20to%20Barroso%2020%20April%2009\\_tcm29-181469.doc](http://www.euractiv.com/29/images/Letter%20to%20Barroso%2020%20April%2009_tcm29-181469.doc).

<sup>26</sup> AIMA statement on European Commission Directive, 23 April 2009, text available at <http://www.aima.org/en/announcements/aima-statement-on-european-commission-directive.cfm>

<sup>21</sup> Proposed Directive, Article 27.

<sup>22</sup> Proposed Directive, Article 26(2).

<sup>23</sup> Proposed Directive, Article 28.

European industries under threat and slow down any economic recovery", Lombard concluded.<sup>27</sup>

It has been suggested that London, as a European centre for fund managers, may be particularly hard-hit by the Proposed Directive. "Because it is regulating fund managers, there is no good reason why somebody should stay in London if they could move to Switzerland [which is outside the EU and is therefore not subject to the Proposed Directive]" argues John Cridland, Deputy Director-General of the CBI.<sup>28</sup>

This risk was identified by Charlie McCreevy, the European Commissioner for Internal Market and Services with overall responsibility for the Proposed Directive. However, speaking at the launch of the

proposals, he said he felt the Proposed Directive "strikes the right balance." The aim, he said, was not to "drive the industry out of Europe and beyond the reach

of European supervisors or to create burdens out of proportion to the risks" but rather to secure "a robust framework to ensure that the sector operates safely and responsibly subject to regulatory oversight."<sup>29</sup>

For some politicians, though, the Proposed Directive does not go far enough. Presumably referring to the €500 million *de minimis* threshold for unleveraged funds, Rasmussen was said to have remarked that "private equity can pop the champagne today but they may not be celebrating for long as we will not accept such an ineffective regulation."<sup>30</sup> As the Proposed Directive moves on to be considered by the European Parliament and European Council, it is likely that the heated debate over its contents will continue.

<sup>27</sup> AIMA statement: EC Directive does not Deliver Proportionate Response, text available at [http://www.aima.org/en/media\\_centre/press-releases.cfm/id/999D2189-AD87-40C4-86B1436063D19423](http://www.aima.org/en/media_centre/press-releases.cfm/id/999D2189-AD87-40C4-86B1436063D19423)

<sup>28</sup> FIN alternatives, April 30, 2009; text available at <http://www.finalternatives.com/node/7778>

<sup>29</sup> The text of Commissioner McCreevy's speech is available at <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/206&format=HTML&aged=0&language=EN&guiLanguage=en>.

<sup>30</sup> Quoted in "UK and Europe heading for rift over regulation", The Telegraph, May 1, 2009, text available at <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/5246128/UK-and-Europe-heading-for-rift-over-regulation.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.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

**Azad Ali**  
London  
+44.20.7655.5659  
azad.ali@shearman.com

**Azam H. Aziz**  
New York  
+1.212.848.8154  
aaziz@shearman.com

**Lorna Xin Chen**  
Hong Kong  
+852.2978.8001  
lorna.chen@shearman.com

**Tobia Croff**  
Rome  
+39.06.697.679.209  
tobia.croff@shearman.com

**Thomas A. Donegan**  
London  
+44.20.7655.5566  
thomas.donegan@shearman.com

**Pierre-Nicolas Ferrand**  
Paris  
+33.1.53.89.71.77  
pferrand@shearman.com

**Laura S. Friedrich**  
New York  
+1.212.848.7411  
laura.friedrich@shearman.com

**Nathan J. Greene**  
New York  
+1.212.848.4668  
ngreene@shearman.com

**Katja Kaulamo**  
Frankfurt  
+49.69.9711.1719  
katja.kaulamo@shearman.com

**Richard Metsch**  
New York  
+1.212.848.7518  
rmetsch@shearman.com

**William R. Murdie**  
London  
+44.20.7655.5149  
bill.murdie@shearman.com

**Barnabas W.B. Reynolds**  
London  
+44.20.7655.5528  
barney.reynolds@shearman.com

**Paul S. Schreiber**  
New York  
+1.212.848.8920  
pschreiber@shearman.com

**Robert C. Treuhold**  
Paris  
+33.1.53.89.70.60  
rtreuhold@shearman.com

**M. Holland West**  
New York  
+1.212.848.4579  
hwest@shearman.com

**John Adams**  
London  
+44.20.7655.5740  
john.adams@shearman.com

**Aatif Ahmad**  
London  
+44.20.7655.5120  
aatif.ahmad@shearman.com

**James Brilliant**  
London  
+44.20.7655.5612  
james.brilliant@shearman.com