SHEARMAN & STERLING LLP

Client Publication

Asset Management, Financial Institutions Advisory & Financial Regulatory | December 8, 2009

Update on the proposed European AIFM Directive: Council and Parliament publish draft amendments

The proposed EU Directive on Alternative Investment Fund Managers (the "Proposed Directive") is currently subject to European legislative scrutiny. The European Council of Ministers and the European Parliament have each published draft amendments to the Proposed Directive. This memorandum highlights some key similarities and differences between those draft amendments and the original Proposed Directive.

Background

The original text of the Proposed Directive on Alternative Investment Fund Managers[1] was published by the European Commission on April 30, 2009. Since then, the Proposed Directive has been the subject of fierce debate and considerable criticism because of the significant implications it has for alternative investment fund managers and indeed investors globally.

In order for the Proposed Directive to be adopted, the European Council of Ministers (the "Council") and the European Parliament (the "Parliament") need to approve a common text under the European Union's "codecision" procedure. That procedure allows the Council and the Parliament to scrutinize the legislation put forward by the Commission and make amendments. There is to-ing and fro-ing between the Parliament and Council until both are in agreement on a final text.

The Council represents the Member States and its meetings are attended by one minister from each State, usually a minister who is an expert on the subject of the meeting and proposed legislation. Parliament is made up politicians elected by the citizens of the EU.

The Presidency of the Council has published amendments to the Proposed Directive in the form of 'compromise proposals' from time to time since October 12, 2009. The latest revised compromise proposal, published on November 25, 2009, is referred to in this note as the "Compromise Proposal".[2] The Parliament published the draft report of the Rapporteur, Jean-Paul Gauzès, on November 30, 2009 (the "Draft Report") which represents the Rapporteur's initial consideration of the Proposed Directive on behalf of the Parliament.[3]

Neither the Compromise Proposal nor the Draft Report represent a final version of the Proposed Directive and each is likely to be subject to further amendment and debate before any common text is agreed by both the Council and the Parliament. However, to the extent that the Compromise Proposal and the Draft Report are broadly in agreement on any particular issue, this is at least indicative of the direction that the final text of the Proposed Directive may take.

---

[1] The text of the Proposed Directive is available, along with press release and frequently asked questions, at http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm.

[2] The Compromise Proposal can be found at http://register.consilium.europa.eu/pdf/en/09/st16/st16622.en09.pdf.

[3] The Draft Report can be found at http://www.europarl.europa.eu/oeil/FindByDocnum.do?lang=en&docnum=COM/2009/207.

The nature of a directive, once adopted, is to require Member States to implement its provisions but to leave the method and form (including the precise wording) of implementation to each Member State (in contrast to a regulation which is directly applicable in Member State laws). Once a directive has been passed there is normally a two year lead time for states to implement the directive by way of national legislation.

This note summarizes what appear likely to be the main features of the final Directive, whilst highlighting the points that are still contentious.

Authorization

Compulsory authorization of fund managers located in the EU

Proposed Directive: Managers located in the EU will require authorization from regulators in order to manage funds.[4] Managers may be authorized to manage all types of fund or only specific types.[5]

Compromise Proposal: The basic authorization requirement is retained, but it is suggested that managers may be authorized to manage funds in accordance with "all or certain investment strategies".

Draft Report: The Parliament also retains the basic authorization requirement, but clarifies that authorized fund managers must comply with the initial requirements for authorization on an ongoing basis.[6]

What is an AIFM?

Proposed Directive: The Commission proposes that alternative investment fund managers ("AIFM") be defined as any natural or legal person who regularly manages funds.[7]

Compromise Proposal: The Council defines an AIFM as any legal person who manages one or more funds - i.e. the idea that an individual can be an AIFM has been dropped. The Compromise Proposal also acknowledges that some funds may effectively be "self-managed" (in which case it is the fund itself that is the AIFM) while others have external managers (in which case it is that external manager that is the AIFM). In addition, it is made clear that each fund must have no more than one AIFM.

Draft Report: Like the Council, the Parliament drops the idea that a "natural person" can be an AIFM, it provides that a self-managed fund will itself be an AIFM, and it states that each fund may only have one AIFM.[8]

Unlike the Council, however, the Parliament appears to suggest that a manager is only an AIFM if it both manages funds and is "responsible" for that management. The intention of the responsibility requirement is not clear, but one assumes that a manager will not be able to circumvent the need to become authorized as an AIFM by disclaiming responsibility for the management of the funds while continuing to act as manager.

As a general point, it is important to remember that the Proposed Directive focuses its regulatory efforts on managers of funds rather than the funds themselves, and neither the Compromise Proposal nor the Draft Report seeks to change this.

In addition, each of the Compromise Proposal and the Draft Report clarifies that the Proposed Directive covers alternative investment fund managers established in the Community (i.e. there is no attempt directly to regulate non-EU managers).[9]

De minimis exemptions

Proposed Directive: The Commission proposes that small fund managers would fall outside the scope of the Proposed Directive. For this purpose, different thresholds are effectively applied to private equity fund managers (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) and hedge fund managers (those

4 Proposed Directive Article 4.

5 Proposed Directive Article 4(2).

6 Parliament Draft Report Amendment 44, new Article 4(2)(1a).

7 Proposed Directive Article 3(b).

8 Parliament Draft Report Amendment 35 and Amendment 49, new Article 6(5a).

9 Council Compromise Proposal Article 1 and Parliament Draft Report Amendment 22.

managing funds with less than €100 million of assets under management).[10]

Compromise Proposal: The Council retains the *de minimis* exemptions referred to above, but adds that any such small fund managers must nevertheless be subject to registration and supervision in the relevant Member State.[11] The retention of this exemption 'as is' is perhaps surprising because the Council raised concerns in its "Issues Note", published in September, about how the thresholds would operate in practice given that the value of a fund's assets can fluctuate (and therefore a manager could fall below or above the threshold for authorization at different times).[12] Rather than amending (or removing) the *de minimis* exemptions, though, the Council suggests that the Commission should adopt implementing measures clarifying how the issue should be dealt with.[13]

Draft Report: In contrast, the Parliament removes the *de minimis* exemptions entirely so that all EU fund managers are caught (unless otherwise exempted). However, in doing so, the Parliament expressly states that the Proposed Directive should not be too burdensome on small funds and that, to ensure that this is the case, the European legal principle of "proportionality" should be applied.[14] The Parliament considers that this proportionality principle should be broadly applied across the entire Proposed Directive and, as a result, there are no specific amendments that would treat smaller fund managers differently to larger fund managers.

The invocation of proportionality as a general principle means that it is difficult to be certain of the obligations that individual managers may face under the Parliament's proposed regime, if adopted.

Once authorized, managers can market EU-domiciled funds to "professional investors"[15]

Proposed Directive: Once authorised in one Member State, a manager may manage and market a fund to professional investors across Europe.[16] This ability to market on a pan-European basis is colloquially known as the "passport".

Compromise Proposal: The Council restricts the passport so that an authorized manager may only market EU funds on a pan-European basis (the ability to market non-EU funds on a passported basis is therefore dropped, although Member States may choose to allow such marketing to professional investors, as discussed below). It is tentatively suggested that an authorized manager may be able to benefit from a passport for non-EU funds in the future.

Draft Report: As with the Council, the Parliament suggests that the passport will only be available to authorized managers in respect of EU funds.[17]

Management and marketing of non-EU domiciled funds by authorized managers

Proposed Directive: The Commission proposes that non-EU funds should only be capable of being marketed to professional investors three years after the final deadline for the implementation of the Proposed Directive. The non-EU jurisdiction in which the non-EU domiciled fund is based would have to enter into an agreement with the relevant Member State where the investors are located which complies with the OECD Model Tax Convention (which governs the exchange of tax information between the relevant authorities).[18]

Compromise Proposal: As described above the ability to market non-EU funds on a passported basis is dropped. However, the Council says that a Member State could allow (in its discretion) authorized managers to market to professional investors in that Member State: (i) a fund

---

10 Proposed Directive Article 2(a).

11 Council Compromise Proposal Article 2a(1)(a).

12 See the 'Issues Note' published by the Presidency of the European Council on September 2, 2009 available at http://register.consilium.europa.eu/pdf/en/09/st12/st12864.en09.pdf.

13 Council Compromise Proposal Article 2a(3)(a).

14 Parliament Draft Report Amendment 16, new Recital 17b.

15 "Professional Investors" has the meaning set out in the Markets in Financial Instruments Directive (Directive 2004/39/EC).

16 Proposed Directive Articles 2(1), 31 and 33.

17 Parliament Draft Report Amendment 116.

18 Proposed Directive Article 35.

established outside the EU (including feeder funds), or (ii) an EU feeder fund where the master fund is located outside the EU.[19]

The Council adds an entirely new provision relating to the management of non-EU funds by EU authorized managers. Such a manager is only permitted to manage a non-EU fund if: (i) the third country (i.e. where the fund is established) has "relevant legislation" that is "in line with" standards set by international organizations such as IOSCO,[20] or the manager can otherwise show that the fund complies with those standards in any case, and (ii) there is a cooperation agreement between the manager's regulator and the third country's regulator.[21]

Draft Report: The Parliament also provides that, subject to national law, a Member State may allow managers to market a non-EU fund into that Member State's territory, but only if either: (i) the manager is domiciled in the EU, or (ii) there are cooperation and information-exchange agreements in place between the Member State and the third country, between the manager and its regulator and between the manager's regulator and the European Securities and Markets Authority ("ESMA"), which is the body intended to supersede the Committee of European Securities Regulators ("CESR").[22]

Each of the Compromise Proposal and Draft Report therefore propose that authorized managers will not be able to market freely non-EU funds on a passported basis. However, each gives discretion to individual Member States to permit the marketing of such funds into their territories, but in slightly different circumstances.

Authorized managers marketing to retail investors

Proposed Directive: The Commission proposes that Member States could, in their discretion, allow authorized managers to market funds to retail investors in their territories.[23]

Compromise Proposal: The Council retains the ability for Member States to market funds to retail investors.

Draft Report: The Parliament also retains the ability for Member States to market funds to retail investors, except in the case of a fund of funds that invests "more than 30%" (presumably 30% of its assets, although this is not made clear) in funds that do not benefit from the European marketing passport (i.e. funds that are not EU funds managed by authorized fund managers).[24]

Marketing by fund managers located outside the EU and "reverse solicitation"

Proposed Directive: A non-EU manager would be able to obtain authorization under the Proposed Directive to market a fund to professional investors provided that the third country meets certain prudential supervision requirements, a cooperation agreement exists between the Member State where the manager is applying for authorization and the third country, the third country has signed a cooperation agreement complying with the OECD Model Tax Convention and the third country grants EU managers comparable market access to that granted by the Community.[25]

Compromise Proposal: These provisions are deleted by the Council. It is not clear whether non-EU managers would be able to continue to market funds on a Member State by Member State basis (as is currently the case).

Draft Report: These provisions are deleted by the Parliament, although Member States may permit marketing by non-EU managers if cooperation and information-exchange agreements are in place between the Member State and the third country, between the manager and its regulator and between the manager's regulator and ESMA.

The issue of non-EU managers having access to the EU investor base has been the subject of enormous

---

19 Council Compromise Proposal Article 31(4a).

20 International Organization of Securities Commissions.

21 Council Compromise Proposal Article 34a (new).

22 Parliament Draft Report Amendment 118, new Article 31(4a). CESR is an independent committee whose role it is to improve coordination between securities regulators, act as an advisory group to the Commission and oversee the timely and consistent implementation of legislation in Member States.

23 Proposed Directive Article 32.

24 Parliament Draft Report Amendment 199, new Article 32(1a).

25 Proposed Directive Article 39.

debate since the Proposed Directive was first published. The Commission proposed to set equivalence requirements that, once met, would allow non-EU managers to market their funds into the EU, but commentators have noted that these would be unlikely to be met in some jurisdictions (including the U.S.). The Commission's draft is criticized as seeking to impose standards on non-EU jurisdictions.

As will be seen from the above, the proposed amendments by the Council and the Parliament do not entirely clarify how non-EU managers will be able to access the EU investor base (other than by means of the "reverse solicitation" exclusion referred to below), and further clarification on this is needed.

Each of the Council and the Parliament has explicitly stated that "marketing" is only caught by the Proposed Directive if that marketing is done "at the initiative of the AIFM".[26] In the Council's initial compromise proposal, dated November 12, 2009, it was clarified that this did not include information on the manager's website but the clarification has since been removed. The inclusion of such a "reverse solicitation" exemption has been the subject of intense lobbying by the fund management industry and others (including large investors). It is seen as being of significant commercial importance.

Master-feeder funds / funds of funds

Proposed Directive: The Commission's draft does not contain any reference to the way in which master-feeder funds and funds of funds might be structured.

Compromise Proposal: The Council stipulates that the European passport cannot be circumvented through master-feeder fund structures so that a fund which invests more than 85% of its assets in a master fund would not be able to be marketed across the Community unless the master fund is established in a Member State and is managed by an authorized manager.[27]

Draft Report: The Parliament proposes that non-EU funds should not benefit from the passport available for EU funds and that these provisions should not be circumvented by master-feeder or funds of funds structures. Therefore, where a feeder fund invests in a master fund which does not benefit from the marketing passport then the feeder fund should not benefit from the passport either. Similarly, where a fund invests over 30% in other funds which would not gain the passport then the fund should not also.[28]

The Commission's proposals do not consider the issue of feeder funds, which is a point which the proposals put forward by the Council and Parliament have attempted to remedy. These amendments have been proposed to ensure funds do not simply restructure in order to access passporting rights.

Authorization conditions, remuneration and disclosure

Authorization conditions

Proposed Directive: Regulators would only grant authorization if they were satisfied that the fund manager was able to fulfil the conditions of the Proposed Directive.[29] A regulator would have two months in which to consider the manager's application for authorization.[30]

Compromise Proposal: The Council proposes additional, more specific, conditions so that a fund manager will have to have sufficient initial capital, the persons conducting the business of the manager must be of good repute and sufficiently experienced in relation to investment strategies, the shareholders or members that have qualifying holdings[31] must be suitable, and the head office and registered office of the manager must be located in the same Member State.

The Council proposes that the relevant regulator would have six months (rather than two months, as previously) to decide on the application.

---

[26] Council Compromise Proposal Article 3(e) and Parliament Draft Report Amendment 38.

[27] Council Compromise Proposal Articles 3(ga) and 33.

[28] Parliament Draft Report Amendment 17.

[29] Proposed Directive Article 6(1).

[30] Proposed Directive Article 6(4).

Draft Report: Parliament does not propose any amendments to the conditions for authorization, although it suggests that the regulator should have three months to consider the application. If the regulator has not approved the application for authorization in that three month period, the application is automatically rejected.

Remuneration

Proposed Directive: The Commission did not propose any provisions relating to the remuneration of authorized managers or their staff.

Compromise Proposal: The Council proposes detailed remuneration provisions [32] whereby an authorized manager needs to establish and apply remuneration policies for all staff (including principals) whose professional activities have a material impact on the risk profile of the manager or the funds it manages. Remuneration policies must not encourage risk-taking that is inconsistent with the business plan and risk profile of the fund.[33] A "substantial portion"[34] of variable remuneration would have to be deferred for an appropriate period,[35] and guaranteed bonuses would not be permitted except in the context of hiring new staff (and even then only for the first year of employment).

The Council proposes that CESR, in conjunction with the Committee of European Banking Supervisors ("CEBS"), should issue guidelines on remuneration policies.

In addition, authorized managers must disclose, both to regulators and investors, on request, the total amount of fixed and variable remuneration paid by the manager (or the fund, where applicable), broken down into categories such as "senior management".[36] The Council's earlier draft compromise proposal, dated November 12, 2009, had stated that where an employee's remuneration was above the average of the board of directors, details of that employee's remuneration in particular would need to be disclosed. That proposition has been removed in the Compromise Proposal.

Draft Report: The amendments proposed by Parliament are not as detailed as the Council's (in that they do not set out specific remuneration principles). However, they do require that authorized managers establish remuneration policies which are compatible with the rules applicable to credit institutions and investment firms.[37] A manager must inform its regulator about the "characteristics of its remuneration policies and practices".[38] The regulator would be able to take corrective measures to offset risks that could result from a manager's failure to comply with the requirement to have sound remuneration policies. No detail is provided as to what those corrective measures might be.

Both the Compromise Proposal and the Draft Report introduce proposals on remuneration that, essentially, are aimed at ensuring the Proposed Directive complies with the principles established at the G20 summit in Pittsburgh on remuneration, and the Financial Stability Board Principles for Sound Compensation Practices. This is an indication by each of the Council and the Parliament that they would like to level the playing field in the financial services sector and avoid, for example, a situation where fund manager staff would be entitled to guaranteed bonuses while those working in investment banks would be prevented from receiving them.

Information to be provided as part of the authorization process

Proposed Directive: Information to be supplied prior to authorization includes the planned activity, location and characteristics of the funds to be managed

---

[31] Council Compromise Proposal Article 8b states that qualifying holdings in an authorised manager will be subject to the same rules as in MiFID.

[32] The detail is set out in a proposed new Annex II to the Compromise Proposal.

[33] Council Compromise Proposal Article 9a, Parliament Amendment 51.

[34] The Council has tentatively suggested that a "substantial portion" for this purpose would be at least 40%, or 60% in the case of "particularly high" bonuses.

[35] Council Compromise Proposal Article 9a, and Annex II. The period in question must be appropriate in view of the life cycle and redemption policy of the relevant fund to which the remuneration relates.

[36] Council Compromise Proposal Article 19(2).

[37] Parliament Draft Report Amendment 50.

[38] Parliament Draft Report Amendment 51.

(including the instruments of incorporation and fund rules), the identities of shareholders in the manager that hold 10% or more of the capital, the amounts held by any such shareholders, governance mechanisms and arrangements for delegation and safe-keeping of assets.[39]

Compromise Proposal: The Council does not make any major amendment proposals on this issue but has recognized that some of the information, such as on delegation, safe-keeping of assets and funds the manager intends to manage, may not be available to the manager when it applies for authorization.

Draft Report: The Parliament proposes that the manager must also provide information on the domiciles of underlying funds (in the case of funds of funds to be managed) and master funds (in the case of master-feeder structures).[40]

Valuators

Proposed Directive:. The Commission proposes that a manager must appoint an independent valuator for each fund that it manages and must ensure that the valuator has appropriate and consistent procedures to value that fund's assets.[41]

Compromise Proposal: The Council dropped the general requirement that an independent third party valuator must be appointed for each fund, although managers would be free to appoint third party valuators if they wish. Instead, emphasis is placed on ensuring the independence of valuation from the portfolio management functions of an authorized manager.[42]

Draft Report: The Parliament retains the original requirement that third party valuators be appointed, but clarifies the Commission's text by stating that any such valuator must be authorized and supervised by a competent authority. The Commission would be obliged to specify in due course who would be eligible to be a valuator. In addition, under the Parliament's proposals, the depositary and the manager will be jointly liable for the valuations, irrespective of any delegation. No justification is given for this provision, although the general tenor is perhaps unsurprising given the extent to which the Proposed Directive seeks to extend the responsibilities of depositaries (below). In this regard it has been recognized that, since the Madoff affair, there is a lack of clarity as to the responsibilities that depositaries ought to have.[43]

The Parliament recognizes that as private equity funds are not traded publicly, and have an investment structure which involves only infrequent trading, any obligation to be valued regularly is inappropriate. Private equity funds are therefore excluded from this provision in the Parliament's proposed amendments.[44]

Depositaries

Proposed Directive: A manager must appoint an independent depositary to act solely in the interest of investors. An authorized manager cannot be a depositary. Only credit institutions recognized under EU law (i.e. banks) are eligible to be depositaries and may only delegate their functions to other EU depositaries. The depositary will be strictly liable to the manager and the fund for any losses suffered as a result of its failure to perform its obligations under the Proposed Directive. The depositary may only discharge its liability for any loss of financial instruments if it shows that it could not have avoided the loss.[45]

The original proposals relating to depositaries have been heavily criticized in previous months[46] and, as expected, each of the Council and the Parliament proposes to extend the types of firms that may act as depositaries, although not to the same degree.

---

39 Proposed Directive Article 5.

40 Parliament Draft Report Amendments 46 and 47.

41 Proposed Directive Article 16.

42 Council Compromise Proposal Article 16.

43 Per Charlie McCreevy, Commissioner for Internal Market and Services at the European Commission, speaking at PriceWaterhouseCoopers' European Asset Management Senior Executive Forum on November 17, 2009.

44 Parliament Draft Report Amendment 62, new Article 16(1a).

45 Proposed Directive Article 17.

46 See our previous client publication on the Proposed Directive at http://www.shearman.com/update-on-the-european-directive-to-regulate-alternative-investment-fund-managers-09-25-2009/.

Compromise Proposal: Under the Council's proposals, authorized managers must appoint, as depositary, either: (i) an EU credit institution, (ii) an EU investment firm authorized to carry out depositary functions (this opens to door for many non-bank authorized firms in the EU to act as depositary), or (iii) any other legal person subject to prudential regulation which can provide sufficient financial and professional guarantees to carry out depositary functions.[47]

The restrictions on delegation are relaxed to some extent, so that custody functions may be delegated (including to sub-custodians in non-EU jurisdictions, provided that the sub-custodian is supervised in its home jurisdiction, has sufficient expertise and meets certain other requirements, including the segregation of custody assets from its own assets).

The strict liability of a depositary is also relaxed. If a depositary can demonstrate that it has exercised all due skill, care and expertise in selecting and monitoring sub-custodians, it may disclaim liability (by contractual agreement) for a sub-custodian's inability to return assets to the fund.

The depositary still remains strictly liable for all other breaches of its obligations, however, unless these occur as a result of abnormal and unforeseeable circumstances out their control, or where their obligations to the fund or the managers conflict with national or EU law.

Draft Report: Like the Council, the Parliament also proposes widening the categories of firm that are eligible to be depositaries to include EU authorized investment firms (although, unlike the Council, the Parliament goes no further than that).

The Parliament also recognizes that depositaries may need to delegate their functions and, broadly, would allow delegation except to the extent that the depositary becomes a "letter box entity" in doing so. How much delegation would be permitted before a depositary becomes a "letter box entity" is not clear.

Unlike the Council, there is no general ability for a depositary to contract out of liability for sub-custodians' failure to return fund assets. However, a depositary will be able to contract out of liability in respect of a sub-custodian if the depositary is forced to appoint a sub-custodian in a particular jurisdiction because of local law in that jurisdiction. One of the criticisms of the Commission draft is that it fails to recognize that, in some jurisdictions, local custodians are required to be used due to local law, and this proposed amendment by the Parliament is an acknowledgement of that.

On liability generally, the Parliament amends the Commission's draft so that a depositary will only be liable for losses suffered as a result of the depositary's "unjustifiable" failure to perform its obligations.[48] This (marginal) watering down of the original strict liability provisions proposed by the Commission is intended to bring the Proposed Directive into line with the equivalent liability thresholds under the UCITS Directive.

Delegation

Proposed Directive: The Commission proposed that any delegation by a manager would require prior approval by its regulator. The manager's liability would not be affected by any such delegation and a manager would not be able to delegate to the extent that it ends up no longer being the manager of the fund. Authorized managers would only be able to delegate management functions to other EU authorized managers.[49]

Compromise Proposal: The Council relaxes the delegation requirements so that a manager only has to notify its regulator in advance of a delegation (rather than seek prior approval). In addition, a manager may delegate management functions to other managers (including non-EU managers), provided that those other managers are "authorized or registered for the purposes of asset management" and provided that, by

[47] Where the fund has no assets that are traded regularly on a regulated market or multilateral trading facility, a manager may alternatively appoint a firm that acts as depositary as part of its professional or business activities and is subject to mandatory professional registration requirements.

[48] Parliament Draft Report Amendment 79.

[49] Proposed Directive Article 18.

delegating, the manager does not become a "letter box entity". The Commission would be required to provide implementing measures to explain what a "letter box entity" means for this purpose.

Draft Report: By contrast, the Parliament effectively retains the idea that any delegation should be subject to prior approval by regulators (although this is dressed up as a notification that can be "rejected" by the regulator). Furthermore, certain key functions (including portfolio management) can only be delegated to other EU authorized managers, as contemplated by the original Commission draft. This is another key difference between the Council's Compromise Proposal and the Parliament's Draft Report.

Minimum capital requirements for authorized fund managers

Proposed Directive: 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.[50] There is an exemption for investment managers who are authorized by the UCITS Directive.

Compromise Proposal: The basic capital requirements set out in the original Commission draft are retained, except that: (i) the maximum capital requirement for any authorized manager would be €10 million, (ii) any self-managed fund must be subject to an initial capital requirement of at least €300,000 and (iii) there is a tentative suggestion that smaller private equity fund managers who fall outside of the Proposed Directive because of the €500 million *de minimis* exemption referred to above, but who nevertheless choose to "opt in" to the directive, would be subject to an initial capital requirement of at least €50,000 or €60,000.[51]

Draft Report: The Parliament also broadly retains the Commission's original proposals and proposes a cap on capital requirements at €10 million. Unlike the Council, though, it goes no further in differentiating between different types of manager.

[50] Proposed Directive Article 14.

[51] Council Compromise Proposal Article 6a(3).

Pre-investment and ongoing disclosures to investors

Proposed Directive: 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, delegation of functions and any conflicts of interests arising as a result, details of the circumstances in which leverage may be used, the types and sources of leverage permitted and any associated risks or restrictions.

Of particular interest to managers that wish to enter into side letter arrangements with investors is a requirement that both (i) the detail of any preferential treatment and (ii) the identity of any investor receiving that preferential treatment must be disclosed to the other investors.

Compromise Proposal: The disclosure requirements are broadly retained. Notably, the Council proposes that, as regards side letters, only the details of any preferential treatment need be disclosed (i.e. the idea that an investor's identity would need to be disclosed has been dropped).[52]

Draft Report: Parliament also broadly retains the original disclosure requirements, although in addition investors must be given information on the domicile of underlying funds (in the case of funds of funds) and of any master fund (in the case of feeder funds). 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, and a description of all fees, charges and expenses borne by investors, including the maximum amounts of any such expenses. Like the Commission's proposals, some of this information will already be provided by managers as a matter of course.

On side letters, unlike the Council, the Parliament unfortunately retains the requirement that the identity of investors receiving preferential treatment under side letters must be disclosed to other investors.

[52] Council Compromise Proposal Article 20.

Ongoing reporting obligations to regulatory authorities

Proposed Directive: In addition to an annual financial report, information to be reported regularly to regulators 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) any use of short selling.[53]

Compromise Proposal: The Council broadly retains all of the Commission's proposals, except in one important respect: rather than requiring regular reporting, the Council suggests that such reporting will generally only be required on request by regulators. The Commission's proposals are criticized as potentially leading to regulators becoming overloaded with data to an unmanageable extent, and the Council has clearly taken that criticism on board in providing regulators with flexibility as to the information it should receive from fund managers. The Council also clarifies that the list of information to be reported is non-exhaustive, so as to enable regulators to require more information on a periodic and *ad hoc* basis if deemed necessary for the purposes of monitoring systemic risk.

However, information relating to the use of leverage by fund managers will still have to be made available to regulators. Specifically, as regards short selling, the Council also says that regulators should share information relating to short selling with each other, CESR (or ESMA) and the proposed new European Systemic Risk Board ("ESRB").

Draft Report: The Parliament retains all of the Commission's original proposals and, unfortunately, does not appear to have acknowledged the concern that regulators could become overly burdened with data. The Parliament does, however, suggest that regulators should provide ESMA and ESRB with any relevant information necessary for systemic risk supervision and, like the Council, clarifies that the list of matters to be reported to the regulators is non-exhaustive, and that additional information may be requested from any manager whom the regulator considers may pose systemic risk. [54]

Additional disclosure obligations for managers engaging in high levels of leverage (and limits on leverage)

Proposed Directive: The threshold for imposing additional obligations on managers for the use of leverage is when a fund "employs leverage on a systematic basis".[55]

When a fund employs leverage on a systematic basis the manager must periodically disclose to investors the amount of leverage used and the maximum level of leverage that can be employed on behalf of the fund.[56] The manager must also disclose to its regulators the overall level of leverage, a breakdown between leverage arising from the borrowing of cash or securities and leverage embedded within derivative instruments, the five largest sources of debt or securities and the amount of leverage received from those sources.[57]

Leverage limits would be imposed in two ways: first, the Commission would adopt implementing measures setting blanket leverage limits for different types of fund, and second, Member States would be able to impose temporary leverage limits in exceptional circumstances.[58]

Compromise Proposal: The Council does not propose to amend the disclosure requirements in relation to the use of leverage.

However, in relation to leverage limits, the Council removes the idea that the Commission should impose blanket leverage limits for different types of funds in all market conditions. The ability of Member States to impose leverage limits in exceptional circumstances is retained. Indeed, the Council extends Member States' powers by providing that, in addition to leverage

[53] Proposed Directive Article 21.

[54] Parliament Draft Report Amendments 93, 94 and 95, new Articles 21(3a) to (3c).

[55] Proposed Directive Article 22.

[56] Proposed Directive Article 23.

[57] Proposed Directive Article 24.

[58] Proposed Directive Article 25.

limits, "other restrictions" could also be placed on managers in such circumstances. This amounts to a remarkably broad and undefined power, although it is suggested that the Commission will adopt implementing measures that clarify when this power might be used.

Draft Report: The Parliament also drops the idea that the Commission should adopt blanket leverage limits for different types of fund. The ability to impose leverage limits in exceptional circumstances has been retained, although the Parliament says that this power should be given to the Commission, acting on the determinations of ESMA and ESRB (rather than enjoyed by Member States, as contemplated by both the Commission and the Council). These limits would have to be of a temporary nature.[59]

Additional disclosure and other obligations for managers holding a controlling influence in issuers and non-listed companies

These additional obligations are likely to be of particular relevance for private equity funds.

Proposed Directive: The Commission proposes that where a manager is in a position to exercise 30% or more of the voting rights of an issuer or non-listed company domiciled in the Community the manager would be required to: (i) notify the company and its shareholders of this, and (ii) provide them all with related information, including as to 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 or exceeded.[60]

The provisions would not apply where the issuer or non-listed company are small or medium-sized enterprises.[61]

The manager would also be required to make certain disclosures to the shareholders of non-listed companies and issuers and their employees (or representatives thereof).[62]

Compromise Proposal: The Council proposes that the threshold at which the notification requirements are triggered should be increased from 30% to 50% of voting rights. The disclosure requirements would not apply if the target company fulfils two or more of the following conditions: it employs fewer than 250 persons; has an annual turnover not exceeding €50 million; and an annual balance sheet total not exceeding €43 million.

The Council also proposes that the manager inform the investors and its regulator of the debt supported by the target company before and after the acquisition and 6 and 12 months thereafter.[63]

Draft Report: The Parliament has broadly retained the Commission's proposals.

Commentary

The sheer extent of the amendments to the Proposed Directive contained in each of the Compromise Proposal and the Draft Report is an acknowledgement of the flaws inherent in the Commission's draft legislation.

Some of the thinking behind the Council's and the Parliament's proposed amendments (including extending the types of firm that may be appointed as depositaries, permitting delegation more widely, and introducing a reverse solicitation exemption for marketing) are very welcome in principle. However, even where it appears that the Council and the Parliament are broadly agreed on what the flaws were in the original Commission proposal, they often have fundamentally different views as to the best way of resolving the matter.

In addition, it must be remembered that the Compromise Proposal is not the Council's final position on the Proposed Directive. Equally, the Draft Report is not the Parliament's final view. Each document will be subject to further debate and amendment and it remains unlikely that a final text will be agreed before the middle of 2010. It has been reported that even Jean-Paul Gauzès, the Parliament's Rapporteur

[59] Parliament Draft Report Amendments 97 to 101.

[60] Proposed Directive Articles 26 and 27.

[61] Proposed Directive Article 26(2).

[62] Proposed Directive Article 28.

[63] Council Compromise Proposal Article 28a.

responsible for the Draft Report, has accepted that the Draft Report was a "foundation", not a "perfect, finalized" solution and that further work clearly needs to be done.[64]

Due to the continued debate, it would be very dangerous to assume that further proposed amendments will be sympathetic to the fund management industry or to investors. There remain significantly different views across Europe and, while many consider that the Compromise Proposal and the Draft Report still unnecessarily restrict the activities of fund managers, others are of the view that the Council and the Parliament's amendments have gone too far and that further restrictions (particularly in relation to leverage and short selling) should be imposed on fund managers.

It is essential that, as the Compromise Proposal and the Draft Report continue to be debated and further amendments are suggested, industry bodies, their advisers and investors continue actively to campaign and lobby members of the Council of Ministers and the European Parliament in an effort to ensure that the final version of the Proposed Directive does not end up damaging the alternative fund industry or EU investors.

[64] Quoted in "Hedge fund legislation needs further work", Financial Times, December 2, 2009 (http://www.ft.com/cms/s/0/9a375a5a-dea6-11de-adff-00144feab49a.html?nclick_check=1).

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

Bill 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

Bertrand Sénéchal
Paris
+33.1.53.89.70.95
bsenechal@shearman.com

©2009 Shearman & Sterling LLP. As used herein, "Shearman & Sterling" refers to Shearman & Sterling LLP, a limited liability partnership organized under the laws of the State of Delaware.