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The Proposed Directive on Alternative Investment Fund Managers – An Update

The Commission of the European Union (the "Commission") has published its Proposal for a Directive on Alternative Investment Fund Managers (the "Directive"). The Directive is designed to introduce a regulatory and supervisory framework for registration and supervision of the managers of alternative investment funds. The Directive will apply not only to the managers of alternative investment funds established in the European Union ("EU"), but also to managers of alternative investment funds established outside of the EU that are marketing (*i.e.,* offering) fund interests in the EU.

Assuming it becomes law, the Directive will have a far-ranging impact on the investment industry, including hedge funds and private equity funds. At this point, however, the provisions, and therefore the impact, of the Directive remain unclear in view of the remaining stages of the legislative process that the Directive must undergo. In particular, the Directive is subject to a co-decision procedure, meaning that each of the European Parliament (the "Parliament") and the Council of the European Union (the "Council") must agree on the final text. On May 17 and 18, a committee of the Parliament, the Committee on Economic and Monetary Affairs ("Econ"), and the Council each adopted a separate version of the Directive. Econ's draft version of the Directive has not yet been officially released. The remaining steps are described below under "The Legislative Process."

The discussion that follows is based on the Council's draft and, where indicated, reported provisions of the Econ draft of the Directive.

The Key Elements of the Directive

The Directive would impose a comprehensive regulatory framework, including disclosure and capital requirements, on a wide swath of the investment industry by regulating the managers ("AIFMs") of alternative investment funds ("AIFs"). The Directive would apply to EU AIFMs (*i.e.,* AIFMs established in an EU member state) that manage one or more AIFs, regardless of whether the AIFs are established in the EU or outside the EU. The Directive would also apply to the marketing in a member state of AIFs managed by AIFMs established outside the EU (so-called "third country" AIFMs). Although the Directive does not attempt to govern AIFMs established in the United States that are marketing AIFs outside the EU, an AIFM established in the United States would be subject to the Directive if it were to market AIFs in the EU.

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The definition of an AIF would be extremely broad and would capture all non-UCITS funds in whatever legal form and wherever established, including hedge funds, private equity funds and real estate funds, unless specifically excluded from the scope of the Directive. Non-pooled investments, such as sovereign wealth funds, special purchase vehicles established to effect securitizations, pension funds and employee savings schemes, national and supranational institutions and funds managing only their own money would be excluded from the scope of the Directive.

An AIFM would be defined as any legal entity whose regular business is managing an AIF. An AIFM could be an external manager or, if an AIF is internally managed, the AIF will be treated as the AIFM for authorization purposes.

Authorization. To operate in the EU, AIFMs would be required to obtain authorization from a member state. Once authorized in one member state, an EU AIFM would be entitled to market AIFs established in the EU to professional investors in any EU member state. The Directive precludes the circumvention of the authorization requirement through use of a master-feeder fund structure.

AIFMs with assets under management of below €100 million (if using leverage) or below €500 million (if not using leverage) would be exempt from the requirement to be authorized. However, the requirements to register and supply certain information would still apply to such AIFMs. Moreover, such AIFMs would not be able to market or manage an AIF in other member states unless they choose to opt-in and become subject to the entire Directive.

The Econ draft would apply different levels of regulation to different types of funds, with the member states retaining discretion to decide which entities would be exempt. Under the Econ draft, private equity funds and non-systemically important AIFMs would only be subject to certain portions of the Directive.

Disclosure. The Directive would require the provision of annual reports to investors (and the filing of such annual reports with the competent authorities[1]), the provision of disclosure to investors before they invest and disclosure to competent authorities of additional information.

An annual report would need to include audited accounting information and would cover, among other items:

- a balance sheet or a statement of assets and liabilities;
- an income and expenditure account for the financial year;
- a report on the activities for the financial year;
- the total amount of remuneration in the financial year, specifying fixed and variable remuneration amounts, the number of beneficiaries and if applicable, any carried interest paid; and
- the aggregate amount of remuneration, broken down by senior management and staff whose actions have a material impact on the risk profile of the AIF.

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1 The term "competent authorities" refers to the national authorities that are empowered by law or regulation to exercise specific supervisory authority.

Disclosure to AIF investors would need to cover, among other things:

- a description of the investment strategy and objectives of the AIF;
- the types of assets which the AIF may invest in and the techniques it may employ and all associated risks, and any applicable investment restrictions;
- the circumstances in which the AIF may use leverage, the types and sources of leverage permitted and the 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, or both;
- a description of the main legal implications of the contractual relationship entered into for the purpose of investment, including information on jurisdiction, applicable law and on the existence, or not, of any legal instruments providing for the recognition and enforcement of judgments in the territory where the AIF is established;
- the identity of the AIFM, the AIF's depositary, the auditor and any other service providers and a description of their duties and the related investors' rights;
- a description of any delegated management or depositary function, the identification of the delegatee and any conflicts of interest that may arise from such delegations;
- a description of the AIF's valuation procedure and the pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets;
- a description of the AIF's liquidity risk management, including the redemption rights both in normal and exceptional circumstances, existing redemption arrangements with investors, and how the AIFM ensures fair treatment of investors;
- a description of all fees, charges and expenses, including the maximum amounts which are directly or indirectly borne by investors;
- whenever an investor obtains preferential treatment or the right to obtain preferential treatment, a description of that preferential treatment;
- the latest annual report;
- procedure and conditions of issue and sale of units or shares;
- the latest net asset value of the AIF or the latest market price of the unit or share of the AIF;
- the liability regime governing the relationship among the external valuer, the AIFM and the investors;
- where available, the historical performance of the AIF;
- any arrangements made by the depositary to contractually discharge itself from liability and any changes with respect to depositary liability; and
- periodically for each AIF: the percentage of the AIF's assets that are subject to special arrangements arising from their illiquid nature, 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.

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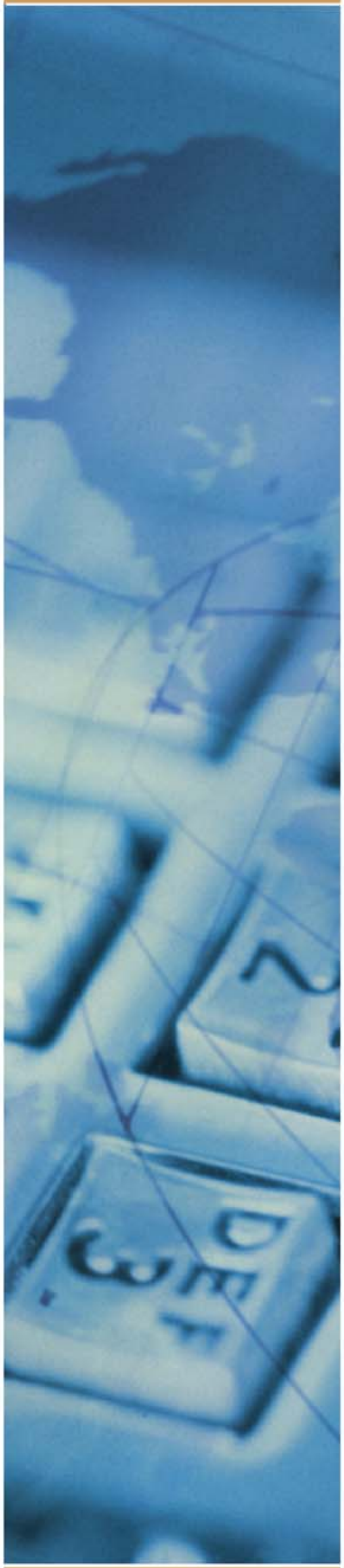

Additional disclosure to competent authorities by an AIFM would need to include, among other things:

- the principal markets and instruments in which the AIFM trades on behalf of the AIFs;
- aggregated information on the main instruments in which the AIFM is trading, markets of which it is a member or where it actively trades, and on the principal exposures and most important concentrations of each of the AIFs;
- for each AIF, the percentage of the AIF's assets that are subject to special arrangements arising from their illiquid nature, any new arrangements for managing liquidity of the AIF, the actual risk profile of the AIF, the risk management tools employed by the AIFM to manage market risk, liquidity risk, counterparty risk and other risks, including operational risk, the main categories of assets in which the AIF has invested, where relevant, the use of short selling, and the results of the liquidity and risk stress tests; and
- if requested by the competent authorities, AIFMs would have to provide an annual report for each AIF for each financial year and a detailed list of all AIFs which the AIFM manages.

Acquiring controlling stakes (defined as more than 50% of the voting rights) in non-listed companies domiciled in the EU (except for stakes in small-and medium-sized enterprises) would trigger notification obligations and also require disclosure to the company and its shareholders. The latter disclosure would include: disclosure of policies for preventing and managing conflicts of interests and policies for communications with employees.

The annual reports of AIFs that have acquired controlling stakes in non-listed companies would have to include additional disclosure related to the acquired company's performance, number of employees and significant divestments of assets. Use of leverage would trigger disclosure to the competent authorities and the AIF investors of information on the debt supported directly or indirectly by the non-listed company directly before and immediately after control has been reached and, without undue delay, whenever material changes occur. These leverage-related disclosures would be required also for acquisitions of controlling stakes in companies domiciled in the EU whose shares are admitted to trading on a regulated market.

The Econ draft would also impose additional restrictions on private equity funds. The Econ draft would limit asset-stripping practices by requiring that portfolio companies owned by private equity funds retain capital in line with the requirements on capital adequacy under applicable company law. When an AIF crosses thresholds of 10%, 20%, 30% and 50% of the voting rights of a non-listed company, the AIFM would have to notify the competent authorities and the investors in the AIF in question. The AIFM would have to provide information on the communication policy with employees and plans for conflict-resolution, and would be required to indicate who is responsible for deciding on business strategy and employment policy. AIFMs would also have to give notice of any planned divestment of assets. These restrictions would not apply to portfolio companies owned by private equity funds if such companies employ fewer than 50 people.

Conduct. AIFMs would need to establish robust governance controls. The Directive distinguishes between risk management and portfolio management, and AIFMs generally would be required to separate the two functions. AIFMs would need to implement adequate risk management systems and review these systems at least once a year. AIFMs would need to implement due diligence procedures based on the investment strategy, objectives and risk profile of the AIF; ensure that risks associated with each investment position can be identified, measured and monitored on an ongoing basis (including through stress testing) and ensure that the AIF's risk profile corresponds to the size, portfolio structure and investment strategies and objectives of the AIF as set forth in the applicable rules, instruments of incorporation or offering documentation.

AIFMs would also need to employ adequate liquidity management systems and procedures, and would be required to conduct regular stress tests to assess liquidity risk. AIFMs would need to ensure that investment strategy, liquidity profile and redemption policies are consistent with one another.

Appropriate procedures would have to be established to ensure that proper valuation of assets of the AIFs can be performed, and that net asset values can be calculated, in accordance with the Directive, at least once a year. The requirements address independence of the valuation function and qualification of external valuers, as well as the valuation process.

Remuneration policies and practices would have to be consistent with sound and effective risk management.

AIFMs would be subject to conduct of business obligations. These would include:

- acting honestly, in the best interests of the AIF or the investors of the AIF and the integrity of the market;
- acting with due skill, care and diligence, in the best interests of the AIF or the investors of the AIF and the integrity of the market;
- having and employing adequate resources;
- trying to avoid conflicts of interest;
- complying with applicable regulatory requirements; and
- treating all AIF investors fairly.

AIFMs would not be able to provide preferential treatment to AIFs unless the preferential treatment is disclosed in the AIF rules or its instrument of incorporation. (This provision could undermine common side letter practices.)

The Commission would be directed to set forth requirements that in effect would prohibit AIFMs from investing on behalf of AIFs in securitized instruments unless the originator retains at least a 5% economic interest in such instruments. The Econ draft would also ban naked short-selling and would require regular disclosure of significant short positions.

Leverage. AIFMs managing AIFs employing leverage would be subject to additional disclosure requirements related to the use of leverage. The additional disclosure to investors would include the maximum level of leverage which the AIFM may employ on behalf of the AIF, as well as any right of the re-use of collateral or any guarantee granted under the leverage arrangement and, periodically, the total amount of leverage employed by that AIF. To the competent authorities, the additional disclosure would include the overall level of leverage employed by each AIF, a break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives and the extent to which assets have been reused under leveraging arrangements, the identity of the five largest sources of borrowed cash or securities and the amounts of leverage received from each of those entities, for each AIF.

Moreover, the competent authorities would be able to impose limits on the level of leverage when the stability of the financial system might be threatened.

Capital requirements. An external AIFM would need initial capital of at least €125,000 (an internally managed AIF would need initial capital of at least €300,000). If the value of the AIFs managed by an AIFM exceeds €250 million, then an additional amount equal to 0.02% of the sum exceeding €250 million would be required, with the total capital requirements capped at €10 million. Moreover, the "own funds" of an AIFM would never be allowed to fall below one quarter of its previous year's fixed overheads.

Depositaries*.* AIFMs would be obligated to engage an independent depositary for the safe-keeping of assets. Only certain types of financial institutions established in the EU would be permitted to act as independent depositaries. Such independent depositary would be liable to investors for any loss of financial instruments held in its custody (and would be obligated to return the instrument of identical type or corresponding amount without undue delay) or for any other losses suffered by them as a result of its failure to perform its obligations under the Directive. The liability may be excused only by unforeseeable circumstances beyond the depositary's control the consequences of which would have been unavoidable despite all efforts to the contrary, and the depositary would carry the burden of proving such circumstances.

Even where the depositary delegates its functions to a sub-custodian, it would remain liable. (However, in the case of a loss of financial instrument by a sub-custodian, the depositary may be able, on a contractual basis, to avoid liability provided that it fulfilled its obligations under the Directive and it is reasonable to have sought exculpation.) Under the Econ draft, a depositary would be liable for the actions of any sub-depositaries appointed by it unless it is prevented by local law from exercising its custodial role in the country where the AIFM is investing or the loss was an unforeseeable external event. Presumably a reaction to the Madoff scandal, these measures could narrow the field of eligible depositaries and substantially increase the cost of engaging a custodian.

Marketing of EU AIFs managed by a EU AIFM*.* An AIFM authorized in a member state would be able to market EU AIFs in that member state to professional investors. That AIFM would also be able to market EU AIFs to professional investors in other member states.

Marketing of third-country AIFs managed by a EU AIFM*.* An AIFM authorized in a member state would be allowed to market third country AIFs to professional investors by the other member states, provided that the AIFM complies with the Directive (except for the depositary provisions, but the AIFM could not also be the custodian and an independent custodian would have to be appointed) and provided that the home member state of the AIFM has concluded a cooperation agreement for efficient information exchange with the authorities of the country where the AIF is established.

Marketing of AIFs managed by a third-country AIFM inside the EU. A third-country AIFM would be able to market either an EU or a third-country AIF to professional investors in a member state, provided that the AIFM complies with the provisions of the Directive related to the provision of annual reports, disclosure to investors, reporting obligations to the competent authorities and disclosure of acquisitions of controlling stakes in non-listed companies. Another condition would be that the member state where the AIF is marketed has concluded a cooperation agreement for the purpose of systemic risk oversight and efficient information exchange with the authorities of the country where the AIFM is established.

The Econ draft would require third-country AIFMs voluntarily to subject themselves to the Directive to be able to market AIFs in a member state. The financial supervisors of that third country would have to act as agents to the EU supervisors in the supervision of the third-country AIFM. Third-country AIFs would be allowed to be marketed in the EU but the third countries where the AIFs are domiciled would have to meet "equivalency" criteria, including having sufficiently rigorous anti-money laundering and anti-terrorist financing rules, granting reciprocal access to marketing of EU AIFs, having information-sharing agreements relating to taxation and monitoring in place with member states and recognizing and enforcing EU courts' judgments on issues connected to the Directive.

EU AIFMs operating outside the EU. An AIFM authorized in the EU would be allowed to manage an AIF that is neither established nor marketed in the EU, provided the AIFM complies with the Directive (except for the independent depositary and the annual report provisions) and provided that the home member state of the AIFM has concluded a cooperation agreement for efficient information exchange with the authorities of the country where the AIF is established. Under the Econ draft, EU investors would be prohibited from investing in AIFs established in countries that lack adequate financial regulations.

The Directive would also encourage the Commission to level the playing field for disclosure of controlling stakes in non-listed companies and impose the requirements applicable to AIFMs with respect to disclosure of controlling stakes in non-listed companies on non-AIFM entities. The Commission would evaluate the relevant member state law within three years from entry into force of the Directive. The Econ draft also encourages the Commission to review existing company law of member states to ensure that companies owned by private equity funds are not at a disadvantage in comparison to companies owned by other means, especially regarding reporting requirements and information that needs to be disclosed to employees. It is unclear what this provision would mean.

The Legislative process

The next step in the legislative process will begin on May 31, when Econ, the Council and the Commission begin holding informal tri-partite meetings to agree on a single draft of the Directive. Assuming that agreement is reached, the draft Directive will be voted upon by the full Parliament and the Council. The next full vote of the Parliament is scheduled for July 6.

The Directive is also subject to the so-called Lamfalussy Process. The Lamfalussy Process is a four-level regulatory approach for the adoption, implementation and enforcement of EU legislation and implementing measures in the securities, banking and insurance sectors:

- level one is the framework legislation, drafted by the Commission and adopted by the Council and the Parliament,
- level two is the detailed implementing measures, drafted by the Commission,

- level three is the drafting and issuance of non-legally binding guidance on the framework and the implementing measures by the Committee of European Securities Regulators, and
- level four is the Commission ensuring that the member states are complying with the legislation.

As a result of this process, the Directive's framework will be expanded and clarified by detailed regulations promulgated by the Commission.

In the final step, member states would have to take legislative action on the national level to transpose the Directive into national law and they will have to do so within two years of the Directive's adoption. If and when the Directive comes into force, there will likely also be a transition period of one to two years before it becomes effective.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to Mark S. Bergman (44-20-7367-1601), Marco V. Masotti ((212) 373-3034), Jennifer A. Spiegel ((212) 373-3748) or Karen J. Hughes ((212) 373-3759).