

European Commission Releases Draft Directive on the Regulation of Alternative Investment Fund Managers

May 27, 2009

Against the background of the international financial market crisis, the EU Commission has issued a first draft of a Directive on the regulation of managers of “alternative investment funds” (“AIF”). According to the explanatory memorandum to the draft Directive, the proposals stem from concerns about the adequacy of the regulatory frameworks of financial markets in the wake of the financial crisis, in particular the perceived lack of supervision over the activities of managers of AIFs.

The draft of the European Commission will be sent to the European Parliament and the European Council for further political discussions and negotiations. Provided that an agreement is reached by the end of 2009, the Directive would have to be implemented by the Member States by the end of 2011 (except for AIFs from third countries, see below).

The rules underlying the Directive are principles-based and will be complemented by detailed implementation measures adopted by the European Commission. Such measures will primarily contain the more technical requirements and will be based on advice given by the Committee of European Securities Regulators (CESR).

Scope of the Draft Directive

The rules of the Directive apply to all AIF managers located in the EU (the AIF itself can be located anywhere in the world). The draft Directive defines AIF as collective investment undertakings, which are not yet harmonized under the UCITS Directive. Therefore, *inter alia*, hedge funds, private equity funds, mezzanine funds, real estate funds, infrastructure funds and commodities funds fall within the scope of the new Directive. Both open-ended and closed-ended funds are covered.

However, the draft Directive only applies to fund managers with assets under management above the €100 million threshold. In addition, AIFs with no leverage and a lock-in period of five years or more are exempt. Such AIFs will fall within the scope of the draft Directive only if they have over €500 million assets under management.

Licence Requirement

Managers of AIFs (as outlined above) will require a licence from the regulatory authorities of their respective home Member States in order

to manage and market AIFs within the EU. They may be licensed to provide management services for either all types of funds or only for specific types and are required to show that they are suitably qualified to provide AIF management services. In relation to this, the AIF manager will have to provide detailed information on the planned activity, identity and characteristics of funds (including the identities of fund members and the instruments of incorporation and fund rules), their internal governance arrangements (including arrangements for delegation), risk management, valuation and safe-keeping of assets, audit arrangements and the systems of regulatory reporting.

The draft Directive only covers the provision of management services for AIFs to professional investors (as defined under MiFID). The Directive does not, therefore, provide rights in respect of the marketing to retail investors. However, the Member States have the right to decide on an individual basis whether to allow managers to market AIFs to retail investors.

Capital Requirements

Managers of AIFs will be required to hold and retain a minimum level of capital of at least €125,000. Additional capital is required if the assets under management exceed €250 million: In such cases the manager shall provide an additional amount of its own funds to 0.02 of the amount by which the value of the portfolios of the AIF exceeds €250 million.

Valuation

An independent valuator must be appointed for each AIF managed by the AIF manager. The valuator will determine the value of the assets acquired by the AIF and the value of the units or shares of the AIF at least once a year.

Depositary

Each AIF must have an independent depositary, which must be an EU credit institution. The depositary shall receive all payments made by investors, safe-keep any financial instruments belonging to the AIF and verify whether the AIF (or the fund manager on behalf of the AIF) has obtained the ownership of all other assets the AIF invests in.

Delegation

AIF managers which intend to delegate functions to third parties may do so with the prior authorisation from the competent authorities of the home Member State. Such authorisation will only be granted if certain requirements are met (the third party must be creditworthy, of sufficiently good repute and sufficiently experienced; the delegation

shall not prevent the effectiveness of supervision of the fund manager). Sub-delegation is not permitted.

Transparency Requirements

The AIF manager is required to make available to investors and competent authorities an annual report for each financial year (no later than four months following the end of the financial year). As a minimum requirement, the annual report shall contain a balance-sheet or a statement of assets and liabilities, an income and expenditure account, and a report on the activities of the financial year.

Furthermore, the draft Directive contains disclosure provisions *vis-à-vis* the investors. The fund manager is required to make sure that investors receive certain information before investing in the AIF. This includes, *inter alia*, a description of the investment strategy and objectives of the AIF, information as to the identity of the AIF's depositary, valuator, auditor and any other service providers, a description of the AIF's liquidity management (including redemption rights), a description of all fees, charges and expenses, and of the maximum amounts thereof which are ultimately borne by the investors, and a description of any delegated management or depositary function, as well as the identity of the third party to whom the relevant function has been delegated.

An AIF manager will also be under an obligation to report to the competent authorities regularly on the principal markets and instruments in which it trades on behalf of the AIF, the AIF's principal exposures, performance data and concentration of risk. Extra disclosure obligations will apply to fund managers managing leveraged AIFs and controlling stakes in companies (see below).

Leverage

Special disclosure and reporting requirements apply should the relevant AIF employ high levels of leverage on a systematic basis. The fund manager shall assess on a quarterly basis whether this is the case and inform the competent authorities accordingly. According to the draft Directive, an AIF shall be deemed to employ high levels of leverage on a systematic basis where the combined leverage from all sources exceeds the value of the equity capital of the AIF in two out of the past four quarters.

AIF managers managing a leveraged AIF shall disclose to investors the maximum level of leverage which the manager may employ on behalf of the AIF, any right of re-use of collateral or any guarantee granted under the leveraging arrangement, as well as the total amount of leverage employed by each AIF in the preceding quarter. Such

disclosure obligations correspond with reporting requirements *vis-à-vis* the competent authorities in the home Member State: The fund manager shall regularly provide information about the overall level of leverage employed by each AIF, a breakdown between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives, and information about the identity of the five largest sources of borrowed cash or securities for each of the AIF and the respective amounts received from each of those entities.

The draft Directive requires the European Commission to adopt implementation measures further specifying the disclosure requirements with regard to leverage and the frequency of reporting to competent authorities.

AIF Acquiring Controlling Influence in Companies

The draft Directive provides for special disclosure and notification requirements where an AIF manager manages an AIF, which either individually or in aggregation acquires 30 per cent or more of the voting rights of an issuer or of a non-listed company domiciled in the EU or where the fund manager has concluded an agreement with one or more other AIF managers, which would allow the AIF managed by these AIF managers to acquire 30 per cent or more of the voting rights of the issuer or the non-listed company. The fund manager shall notify and make available certain information to the issuer or the non-listed company, all other shareholders and the representatives of employees (and where there are no representatives of employees the employees themselves).

However, non-listed companies, which are small or medium enterprises that employ fewer than 250 persons, have an annual turnover not exceeding €50 million and/or an annual balance sheet not exceeding €43 million are exempt from such special disclosure and notification requirements.

Cross-Border Marketing and Management

AIF managers may market shares or units of an AIF to professional investors in another Member State or manage an AIF domiciled in another Member State. The only requirement for such activity is the conclusion of a notification procedure during which certain documents are submitted to the competent authorities of the home Member State and from there transmitted to the competent authorities of the Member State where the relevant AIF will be marketed or managed.

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

No part of this publication may be reproduced, in whole or in part, in any form, without our prior written consent.

© 2009 Dewey & LeBoeuf LLP
All rights reserved.

For further information on Dewey & LeBoeuf, please visit www.dl.com

Specific Rules in Relation to Third Countries

The Directive recognizes that the management of offshore funds is an important feature of, in particular, private equity and hedge fund models. AIF managers may market shares or units of an AIF domiciled in a third country to professional EU investors if the fund complies with stringent requirements on regulation, supervision and cooperation, including tax matters. Details will be laid down in the implementation measures. Therefore, the rules allowing the marketing of third-country AIFs will come into force three years after the rest of the Directive. In the meantime, third-country AIFs will continue to be marketed in those Member States which currently allow such activity.

Under certain conditions set out in the draft Directive (AIF manager is subject to equivalent prudential regulation and ongoing supervision, etc.) Member States may authorise an AIF manager established in a third country to market units or shares of an AIF to professional investors in the EU.

Grandfathering

AIF managers operating in the EU before the deadline for the transposition of the Directive shall adopt all necessary measures to comply with the Directive and shall submit an application for authorisation within one year of the deadline for the transposition of the Directive.

Outlook

The draft Directive is highly controversial among politicians. Some high-profile European politicians argue that the funds themselves instead of the fund managers should be regulated. They also criticise that the issue of naked short selling is not addressed within the new regulatory framework. We will keep you updated.

If you have any questions regarding this alert please contact:

New York: Joseph A. Smith at +1 212 259 7268 or jsmith@dl.com.

Milan: Davide Contini at +39 02 3030 9330 or dcontini@dl.com, Pietro Massimo Marangio at +39 02 3030 9330 or pmmarangio@dl.com.

Paris: Jean Goncalves at +33 1 53 93 75 35 or jgoncalves@dl.com.

Warsaw: Lejb Fogelman at +48 22 690 6110 or lfogelman@dl.com.

Frankfurt: Dr. Kai-Uwe Steck at +49 69 3639 3390 or ksteck@dl.com, Dr. Nicole Campbell at +49 69 3639 3380 or ncampbell@dl.com.