

6 May, 2009

European Commission Announces Proposed Alternative Investment Fund Managers Directive

On April 30, the European Commission announced a proposed Alternative Investment Fund Managers Directive (the “Proposed Directive”). The Proposed Directive requires approval by the European Parliament and the European Council before it can become effective. It will not come into force until two years after that approval, so the earliest that it may become law in member states is late 2011.

The Commission stated in the press release accompanying the Proposed Directive that it anticipates “intense political discussion and negotiation” in view of the subject matter. It is clear that when the Directive is finally enacted it is likely to differ from the Proposed Directive, possibly in significant respects.

The Proposed Directive will apply to alternative investment fund managers (AIFMs) managing more than €100 million (approximately \$130 million) in assets. A higher threshold of €500 million (approximately \$665 million) applies to AIFMs which do not use leverage and which have a lock-in period of five years or more. The conditions applicable to this higher registration threshold mean that it will primarily be applicable to private equity fund managers. The €100 million threshold is lower than it appears, as it includes assets acquired through the use of leverage.

Alternative investment funds (AIFs) are defined to include not just hedge funds, private equity funds and other alternative investment funds, but all funds which are not UCITS funds meeting the requirements of the UCITS Directive 85/611/EEC (UCITS funds being open-ended funds investing in transferable securities and certain other financial instruments which can be marketed to the general public in EU member states). This will include, for example, real estate funds, commodity funds and infrastructure funds. As currently drafted, it appears also to include a long-only fund which does not fall within the UCITS Directive.

The main provisions of the Proposed Directive are briefly summarised below.

1. AIFMs Required to Be Authorized

AIFMs located in EU member states will be required to be authorized by the financial services regulator in their home state in order to provide management services to AIFs, or to market AIF interests. The authorization requirement applies irrespective of whether the AIF in question is an EU or non-EU fund and irrespective of the legal structure of the fund or the manager. It supplements the existing authorization requirement under the EU Markets in Financial Instruments Directive (2004/39/EC) which applies to any person who manages investments.

A potentially significant carve-out states that the Proposed Directive will not apply to credit institutions. So where an AIFM is a division of an EU-regulated bank—but not a separate corporate entity—it will not be subject to any of the requirements of the Directive.

For more information, please contact:

Martin Cornish
+44 (0) 20 7776 7622
martin.cornish@kattenlaw.co.uk

Edward Black
+44 (0) 20 7776 7624
edward.black@kattenlaw.co.uk

www.kattenlaw.co.uk

2. Conditions for AIFM Authorization

As would be expected, AIFMs will be required to show that they are fit and proper persons and suitably qualified to act as fund managers. In addition, it will be necessary to provide detailed information about each of the funds that the AIFM intends to manage and how all of the ongoing regulatory requirements will be met.

3. Financial Resources Requirements

AIFMs will be required to have their own funds of not less than €125,000 plus an additional sum of 0.02% of the amount by which their assets under management exceed €250,000.

4. Ongoing Regulatory Requirements

AIFMs will be required to comply with defined standards with respect to management of risk, liquidity, conflicts of interest and with respect to general conduct of business standards.

They will be required to file information with their home state regulators with respect to their principle exposures, performance data, risk concentrations and use of short selling.

Where an AIF employs “high levels of leverage” or acquires stakes of 30% or more in listed or unlisted companies, additional reporting and disclosure requirements will apply. A fund will have a high level of leverage if its combined leverage from all sources exceeds its equity capital, so virtually all hedge funds will be subject to this requirement.

5. Appointment of Key Service Providers

AIFMs will be required to appoint a depositary which is an EU-regulated bank as well as a regulated independent valuation agent (termed a “valuator” in the Proposed Directive) for each AIF they manage. Where the depositary delegates all or part of its duties to a sub-depositary, it will remain liable for the sub-depositary’s acts and omissions. The use of non-EU entities is severely limited.

Each delegation of any of its functions by the AIFM is subject to prior approval by its home state regulator. The AIFM’s liability to investors is not affected by this delegation.

6. Disclosure to Investors

There is an abundance of detailed pre-investment and ongoing disclosure requirements. In many cases these are more stringent than the information currently customarily provided to fund investors. For example, the investment strategy for each AIF and the assets it can invest in will need to be disclosed in more detail than is currently the norm.

In addition, the Proposed Directive goes further than the currently required side letters disclosure. The identity of any investor receiving “preferential treatment” must be disclosed to all investors where any investor is given preferential treatment or the right to it, along with a description of the applicable preferential treatment.

7. Private Placement Regime

The Proposed Directive envisages AIFMs being permitted to market alternative investment funds to professional investors throughout the EU under a private placement regime. This will apply to funds established in non-EU jurisdictions only after a transitional period of three years from the date the Proposed Directive comes into effect. Further, it will only be possible to market to investors in an EU member state if that state has signed with the home jurisdiction of the fund an agreement which fully complies with the standards laid down in Article 28 of the OECD Model Tax Convention to ensure an effective exchange of information on tax matters.

Marketing under the private placement regime will only be open to entities which are authorized as AIFMs. Managers which are authorized in non-EU jurisdictions can be granted access to the private placement regime if their home jurisdiction provides equivalent regulatory protection, enters into information-sharing agreements and provides equivalent access to EU AIFMs. It is not at all certain that any jurisdiction will be able to meet this test.

What Happens Next?

As we said above, the legislative process is likely to be hard fought. On one side, the UK government and industry bodies such as the Hedge Fund Standards Board and the Alternative Investment Management Association have condemned the Proposed Directive as too heavy handed. On the other side, the Socialist Group of the European Parliament has expressed its dismay that the proposal does not go far enough. The Socialist Group has spoken of a “proposal filled with loopholes which make the real regulatory affects highly ineffective” and is complaining that the Commission is proposing to regulate “only fund managers” and not the funds themselves.

Where the Proposed Directive differed from various drafts that became public prior to its official release, the Proposed Directive applies more stringent standards or requirements in almost every respect. So far, it seems, the opponents of hedge funds, private equity funds and other AIFs appear to be in the ascendancy.

Katten

KattenMuchinRosenmanCornish LLP

www.kattenlaw.co.uk

1-3 Frederick's Place • Old Jewry • London EC2R 8AE
+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax

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The Members of Katten Muchin Rosenman Cornish LLP (who for convenience only refer to themselves as Partners) are: Martin Cornish, Jack Governale (U.S. lawyer), Arthur W. Hahn (U.S. lawyer), Daniel Huffenus (U.S. lawyer), Andrew MacLaren, Imran Sami, Andrew Turner and Sam Tyfield.

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