Skadden

Skadden, Arps, Slate, Meagher & Flom LLP
& Affiliates

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

London
Allan Murray-Jones
+44.20.7519.7199

Julie M. Bradshaw
+44.20.7519.7013

James Anderson
+44.20.7519.7060

Munich
Walter R. Henle
+49.89.244.495.111

Frankfurt
Mathias G. Gaertner
+49.69.74.22.0173

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European Directive on Alternative Investment Fund Managers

Keep Calm and Carry On

The European Commission has released a first draft of a Directive on Alternative Investment Fund Managers (AIFM and AIFM Directive). According to the European Commission, the proposed AIFM Directive "aims to create a comprehensive and effective regulatory and supervisory framework for AIFMs in the European Union," as "an important part of the European Commission's response to the financial crisis." If implemented in anything like its current form, the AIFM Directive will have wide-ranging implications for the operations of all non-retail investment fund products operating in Europe (probably less so for European private equity fund managers who have adopted best practices than for others). The proposed Directive will affect the operators of non-EU funds to the extent they want to provide management services in Europe or market their products to even the largest European investors.

This memorandum outlines, and comments on, some of the key provisions of the proposed AIFM Directive. It is not intended to be comprehensive or to be a summary of the draft Directive, which we are happy to supply to clients on request.

By way of a preliminary overarching comment, even by EU standards this is a heavily negotiated document and exhibits complex compromises. It has been drafted by people with little industry knowledge. There clearly will be many changes before it is adopted. So at this preliminary stage, industry participants really do need to keep calm and carry on.

Context of the Proposal

There is a highly political background to the proposed Directive.

Some forms of funds have been under attack in Europe for a long time. For example, a senior German minister famously called private equity funds "locusts," probably because of the perception that employment is less secure for workers in companies controlled by such funds. And a number of European governments, including France and Germany, have been very concerned about the cost to their tax systems arising from the operations of such funds.

Other politicians, particularly in France, have expressed concern about the operations of hedge funds, particularly in terms of their holdings in French companies, and short selling.

More recently, public opinion in most EU jurisdictions, reflected by politicians, has been hugely influenced by the effects of the credit crunch. The French president has said that this will lead to the end of "laissez-faire capitalism." A lot of these criticisms in Europe, outside the UK, also are aimed at "Anglo-Saxon economics." These sorts of public concerns are too widespread not to cause institutions like the Commission to react, and because a lot of the concern is generic, there is little political will to ask whether the

nature of the existing regulation of managers of alternative investment funds has very much to do with our current economic difficulties (although the implications of the Madoff affair clearly show that the operation of some funds does have the potential of causing widespread harm). The EU cannot act unilaterally on the regulation of banks that may be perceived as a more primary cause of the credit crunch. So when the Commission decided it had to respond, regulation of investment fund managers seemed appropriate.

There are also specific Commission aspects of this. The Commission has long been of the view that its influence on international financial matters, compared to that of U.S. government entities, is too low. Regulating AIFMs is an opportunity to become a leader in an area where U.S. regulators have had virtually nothing to say. More positively, the Commission is concerned about the multiplicity of regulatory approaches to alternative investment funds in Member States, which in the absence of a European Directive are likely to become even more disparate. And of course there are benefits for fund managers themselves in being able to operate in, and market their products throughout, the EU without having to comply with a large number of different national rules and regulations.

The European Law Making Process

Ultimately a directive such as the AIFM Directive is going to need to be approved both by the European Parliament and by the European Council (that is, European governments acting by a majority). The Socialist group (the second largest in the European Parliament) has already made clear that it thinks that the draft Directive does not go nearly far enough in terms of the regulatory structure for funds, as has the (supposedly conservative) French government (although in the latter case there may be an element of trying to reduce the current dominance of the UK in relation to funds). Such is the nature of the EU legislative process that the president of the EU Commission has himself, according to some reports, been very critical of his own Commission’s proposals.

The aim will be to bring everything together to adopt the Directive no later than 2011, after which it will need to be legislated into the local law of each EU Member State.

Therefore, we are some years away from any change, and have time for a serious review of the draft Directive and for interested parties to try to influence local lawmakers on how it is to be implemented in each jurisdiction. One would hope that economic recovery will have started relatively early in this drawn-out process, perhaps reducing the public pressure that has led to some of the more unsatisfactory elements of the draft and allowing for rational consideration. Equally, this process gives fund managers and investors plenty of time to develop new structures that comply with the new requirements whilst enabling investors to meet their commercial objectives, in each case subject to new restrictions and possible additional costs.

In the context of timing, Member States will be permitted (but not required) to allow non-EU funds to be marketed in their jurisdiction for three years after the Directive is adopted. The situation thereafter is as set out below.

Key Elements of the Proposed AIFM Directive

- ***Scope***. The proposed AIFM Directive applies to all funds not regulated under the UCITS Directive (Undertakings for Collective Investments in Transferable Securities). Broadly, the UCITS Directive applies to all retail funds in the EU, so the proposed Directive will apply to the managers of all other “funds” (which would appear to include companies). So whilst

most of the commentary to date has been about hedge funds and private equity funds, the Directive also will apply, among others, to a broad range of commodity funds, real estate and infrastructure funds, and corporate "funds" (such as British investment trusts, although there has to be a possibility that the Commission did not realise its drafting was so wide). Note that this means that the Directive will apply to managers with respect to existing funds when its requirements come into force, so some amendments will be required.

- ***De minimis exemption***. The proposed Directive will apply to all AIFMs managing a portfolio with total assets of more than Euro 100 million. A higher threshold of Euro 500 million will apply to managers of funds that (i) do not use leverage (which is believed to be borrowings by the fund itself and not the entities in which it invests, although this is not entirely clear) and (ii) provide for a five-year lock-in period for their investors. The Commission believes that most private equity funds have these features (although few have express lock-in periods) and the higher threshold applies since these types of AIFM are assumed by the European Commission not to pose a systemic risk for financial stability (which of course raises the question why, once the thresholds are met, such funds are treated in exactly the same way as other funds).

- ***Authorisation required***. All AIFMs established in the European Union will be required to obtain authorisation from the competent authority of their home Member State regulator in order to manage and market their investment funds in the European Union.

  - *General requirements*. In order to become authorised, AIFMs will be required to demonstrate to the appropriate regulator that they are suitably qualified to provide AIFM services and will be required to provide detailed information on their planned activity, identity and characteristics of the fund managed, governance and arrangements for internal risk management, valuation and safekeeping of assets and audit and regulatory reporting systems, where required. Most EU States currently have requirements of some sort in this area.

  - *Minimum capital*. An authorised AIFM will be required to have a minimum level of capital. The base amount of required capital is Euro 125,000; where the value of the portfolios of funds managed by the AIFM exceeds Euro 250 million, the AIFM shall provide for an additional amount of capital equal to the higher of one quarter of "fixed annual overheads" and to 0.02 percent of the amount by which the value of the portfolios of funds managed exceeds Euro 250 million. These are not large sums for larger private equity funds, which is one reason why many European private equity fund managers are less concerned about the draft Directive than are, say, hedge fund operators. The minimum capital must be maintained so that operating losses may be replenished, if necessary. Capital does not, of course, need to be in the form of cash held at a bank, but more detailed information will be required to see if, for example, it could be represented by investments in managed funds.

- ***Effect of authorisation***. There are intended to be benefits in authorisation.

  - *Rights of an AIFM upon authorisation*. Any AIFM authorised will thereupon be entitled to market funds to professional investors. Member States may allow for marketing of alternative investment funds to retail investors within their local

territory and may apply additional regulatory requirements for this purpose. AIFMs also may be able to provide services in other Member States.

- *EU-passporting*. The EU wide marketing of alternative investment funds and the provision of management services in other Member States will be subject to a notification procedure.

- **Operational requirements**. The following provisions are among those that will affect the operations of funds to which the draft Directive applies.

  - *Ongoing reporting obligations*. Each AIFM will be required to report to the competent home Member State regulator (that is, the one that authorised it) on a regular basis about the principal markets and instruments in which it is active, its principal exposures, performance data and concentrations of risk and certain other information about its activities. Additional disclosure obligations will apply to an AIFM managing leveraged funds and controlling stakes in companies. In addition, all AIFMs will be required to issue annual reports to their investors and disclose certain prescribed information (which many European private equity funds have been doing voluntarily).

  - *Additional obligations for AIFMs managing funds that acquire a controlling stake in companies*. An AIFM managing funds that acquire individually or in the aggregate 30 percent or more of the voting rights of a company domiciled in the European Union will be required to notify the company and its shareholders of that control and provide certain information including, the voting rights held, information about the identity of the different shareholders involved, and the date on which the threshold was reached or exceeded. These additional requirements do not apply where the company employs fewer than 250 persons, has an annual turnover not exceeding Euro 50 million and/or an annual balance sheet not exceeding Euro 43 million. These requirements are less onerous than some existing regimes. Additional disclosures will apply to public companies that are taken private for a period of two years.

  - *Valuation*. All funds must have a valuer, independent of the manager, to value assets every year and on issue of interests or on redemption. No reason is given why the professional investors might require this rather than, say, the now common (in Europe) process of the manager carrying out the valuation, subject to a review, as part of the audit process. There will be restrictions on the use of non-EU valuers. This will clearly be expensive and time-consuming for funds holding illiquid assets.

  - *Custodian*. All assets must be held with a bank custodian. Even if the fund (or its assets) are held outside the EU the custodian must be an EU bank, although non EU funds marketed in the EU may use non-EU, custodians, subject to stringent requirements that require, inter alia, supervision equivalent to EU law.

  - *Delegation*. Delegation of fund management, administration and marketing functions will require (in each case) approval from the applicable regulator (which sounds like a huge administrative burden for regulators).

– *General duties*. Managers will be required to act in the interests of the fund, its investors and "the integrity of the market." The first of those two probably already apply. No guidance at all is given on what the duty to the integrity of the market might mean, and it presumably is wider that existing prohibitions on market abuse. The sanctions for breach of this requirement are not specified.

– *Further requirements*. There are further requirements in the areas of conflicts of interest, risk management, due diligence on investments, liquidity and fair treatment of investors (which is unlikely to be consistent with side letters, unless a full set is provided to all investors). Most larger EU-based fund managers will be used to these types of requirements.

– *Leverage*. There are reporting requirements for the use of leverage (as above, this probably means use by the fund, not by investee companies), and the EU Commission will set overall limits on leverage.

– *Employee information*. Of particular interest to private equity investors will be the need for AIFMs to provide certain information (including "development plans") to employee representatives in investee companies (or if there are no representatives, directly to the employees themselves).

– *Contemporary worries*. One entirely new requirement will be restrictions on investment in "securitisations," including a ban on doing so if the originator under the securitisation has not retained a 5 percent economic interest in the securitisation assets (this looks more like an attempt to regulate securitisations than to regulate funds, although the concern this reflects is widely held). Similarly, and equally reflecting the rag bag of concerns underpinning the proposed Directive, is in effect a ban on naked short selling (short selling having been a particular concern to EU regulators (and indeed U.S. and other regulators worldwide) in recent times).

- ***Third-country funds***. AIFMs may only market shares or units of an alternative investment fund domiciled in a third country outside the European Union to professional investors domiciled in a Member State if the third country complies with stringent requirements on regulation, supervision and cooperation and ensures "an effective exchange of information in tax matters." This condition shall ensure that local tax authorities receive information to tax domestic investors in accordance with OECD standards. These rules will come into force three years after the main part of the AIFM Directive has entered into force. In the meantime, third-country funds may continue to be marketed in those Members States that allow it. AIFMs will not require authorisation if they manage funds that are not domiciled in the EU if such funds are not marketed in the EU.

- ***Third-country AIFMs***. Member States may authorize AIFMs established in a third country to operate in the European Union if the third country's legal framework is regarded as equivalent to the ongoing supervision and prudential regulation standards under the AIFM Directive. In addition, among others, the regulator of the Member State and the competent supervisory authority of the third-country AIFM have to enter into a cooperation agreement that ensures an efficient exchange of certain information about the activities of the AIFM. Further, the respective third country has to cooperate with the local tax author-

ities in the Member State to ensure proper taxation. The European Commission will adopt general criteria to assess whether a third country is meeting these requirements. These rules also will come into force three years after the implementation of the AIFM Directive; in the meantime, third-country AIFMs may continue to operate in those Members States that currently allow it.

Thoughts

We have made comments above in relation to the context in which the draft Directive was prepared, and on some of the specific provisions.

Our reaction to the proposed Directive overall is to be concerned, if not surprised, by how challenging some of it is. It was clearly very contentious within the Commission, perhaps illustrated by the fact that the Commission press release about it and responses to "frequently asked questions" were released two days before the draft Directive was.

But legislative process in Europe often starts this way and ends up with a relatively satisfactory outcome (which may well differ from some legislation that starts in the U.S. Congress and never gets proper review). So it is not time to panic. There is a lot that can be done to fix some of the more onerous provisions. And in some cases national legislation implementing the Directive can iron out some of the more obvious problems. The bigger risks are that the political imperatives in Europe (referred to above under "Context") make this impossible or lead to additional areas of concern. The requirement to use EU valuers and custodians may well be challenged under international trade law.

Ironically, of course, the biggest losers may be European investors who will ultimately not be able to diversify as they wish, or find that doing so is more expensive. And those investors hold the investments of other European savers and pensioners.

No doubt U.S. pension funds faced similar problems when the ERISA legislation was first enacted. And as with ERISA, over time fund managers and investors will find a way to deal with much of the effect of any new law. A few ways of dealing with the difficulties, if the proposal is not changed, include the use of parallel structures in which a U.S. fund invests alongside a fund established and run by the European subsidiary of its manager (perhaps charging higher fees to investors in the European fund of its local subsidiary because of the cost of complying with the proposed Directive); complex feeder structures (more expensive of course for the Europeans, and possibly less tax efficient, but which allows compliance with the new rules); or if, feeder structures are prohibited, the use of agency agreements between fund managers and individual investors so that there is no "collective undertaking."

There is a lot of time for the draft Directive to develop, and for responses to it, which meet the commercial needs of investors, and fund managers to be implemented.

40 Bank Street, Canary Wharf, London, England
Telephone: +44.20.7519.7000

Four Times Square, New York, NY 10036
Telephone: 212.735.3000