

Proposed EU Directive on Alternative Investment Fund Managers
by
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This outline addresses the European Commission’s (the “EU”) proposal for a Directive meant to establish an EU framework for the authorization and operation of alternative investment fund managers (“AIFM”). Of particular focus are non EU domiciled managers and funds and EU managers seeking investors for non EU domiciled funds.²

General

On April 30, 2009, the Commission of the European Communities (“EU Commission”) published a “Proposal for a Directive of the European Parliament and the Council on Alternative Investment Fund Managers.” The Directive relates to activity within the EU Member States. Jurisdictions outside of the EU are referred to as Third Countries.³

Who is affected? What is an AIF? AIFM?

Virtually all investment managers and “collective investment undertakings” are covered by the Directive. As drafted, the Directive applies to any natural or legal person established in the EU who manages one or more AIFs and which provides management services to one or more AIFs regardless of its domicile. The Directive in current form affects:

1. Hedge funds, private equity funds, venture capital funds, and real estate funds (collectively referred to as “Alternative Investment Funds” or “AIFs” in the Directive)

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² This memorandum is for educational purposes only and is not to be construed as legal advice to any person in any jurisdiction. It may be considered attorney advertising.

³ The EU Member States are Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and United Kingdom

2. Persons or entities rendering “management services” to AIFs. These are referred to as “Alternative Investment Fund Managers” or “AIFMs” in the Directive and include:
 - a. Investment advisers and managers of any of the above
 - b. Administrators
3. Custodians
4. Valuation agents and appraisers
5. Delegates of the above (sub-advisers, sub-custodians etc.)

The Directive by its terms exempts UCITS from coverage.⁴

In general terms, what is prohibited?

The Directive generally prohibits any AIFM which is not authorized by a Member State of the EU from providing management services to any AIF domiciled in the EU and prohibits a non EU domiciled AIFM from “soliciting” investors in the EU. Note that the focus of the Directive is on the AIFM and not the AIF itself. This is similar in approach to the United States requirement to register the AIFM (if certain conditions are satisfied) and not the AIF itself.

What is definition of “management services”?

The term “management services” is defined as “managing and administering” but the Directive does not go into any detail as to what “managing” means or what “administering” means. It would appear to include investment management, risk management and other services.

Are there operating conditions imposed for AIFMs?

The Directive imposes a number of business requirements on AIFMs including, without limitation, a duty to:

1. act honestly, with due care, skill and diligence and fairly in conducting its activities;
2. act in the best interests of the AIF it manages, its investors and the integrity of the market;
3. act in a manner that treats investors fairly;
4. identify the conflicts, and manage those conflicts;
5. operate its organization effectively; and
6. structure its internal organization such that risk and portfolio management are separated.

⁴ UCITS are essentially mutual funds designed for retail investor consumption. They are established under the Undertakings for Collective Investments in Transferable Securities Directive (the “UCITS Directive.”)

Many of the conditions seem obvious, but some raise issues. For example, is it always possible for an AIFM to act in the best interest of the AIF, the best interest of the investors and preserve market integrity all at the same time?

How are “side letters” affected?

No investor can receive beneficial treatment unless disclosed to all investors in the AIF. Accordingly, the Directive would essentially require all side letter arrangements disclosed to all investors.

1. Whether or not material.
2. Investors’ identity would be disclosed.

What standards would be imposed by the Directive?

1. Risk Management. The Directive mandates that there be a separation between risk management and portfolio management.
2. Short sales. There is a specific concern with and focus on short selling. The EU Commission is to set forth rules with regard to short sales.
3. Liquidity management. The AIFM must adopt procedures and implement appropriate liquidity management policies to ensure that its liquidity profile is consistent with its investment strategies.
 - a. Regular stress testing is required.
 - b. AIF redemption policies need to be consistent with liquidity management policies, and vice versa.
4. Leverage. Disclosure to investors and regulators on a quarterly basis. The EU Commission is authorized to establish standards.
5. Independent valuator is required.
6. Independent Administrator is required.
7. Independent Depositary is required and must be a credit institution authorized in the EU.

What AIFMs are exempted under the Directive?

Under the Directive, the following AIFMs are exempt from seeking authorization:

1. AIFs that use leverage: Any AIFM with assets under management (in the aggregate) of €100 million or more.
2. For AIFs that do not use leverage, the threshold is raised to €500 million provided the AIF has no redemption right that is exercisable during a 5 year period following the start up of the AIF.
3. Certain banks, insurance companies, pension funds, etc.
4. AIFMs that render services only to UCITS.

Are there minimum capital requirements being proposed?

Yes. Each AIFM must maintain at least €125,000 in regulatory capital. Where the aggregate value of the AIFs exceeds €250,000 then the AIFM must maintain additional capital of .02% of the excess over €250,000.

Can an EU domiciled manager hire a non EU sub-manager? Can a non EU AIFM hire an EU AIFM? How is delegation handled?

This kind of delegation is virtually impossible because under the Directive a sub-manager or delegate with regard to portfolio management services or risk management functions for an EU AIFM would need to be able to provide that service in its own right in the EU, i.e. would need to meet the requirements of the Directive itself. This would seem to prohibit delegations, sub-advisory agreements and even parent subsidiary relationships to AIFMs who do not meet the requirements of the Directive.

How are administrators and other service providers affected?

An EU AIFM would need to seek authorization from its home Member State before a third party service provider can be appointed for the AIF.

Authorization

A. Generally

Presumably there will be some procedure established by which an AIFM can become authorized in its Member State to render services to an EU AIF. But as to non EU domiciled AIFMs, the Directive does not permit such AIFMs from even seeking authorization under the Directive to manage an EU AIF. One possible alternative is for the non EU AIFM to establish a subsidiary in the EU and seek approval from there but in light of the strict delegation rules (described below) it is doubtful whether this type of strategy will be practical.

B. Marketing and Authorizations. How is marketing, even to sophisticated and high net worth investors, affected?

1. Non EU AIFM marketing to EU investors is generally not permitted.
 - a. After a three year waiting period following the effective date of the Directive, a non EU AIFM would be permitted to apply for authorization to market to “professional clients” if:
 - i. The EU Commission has determined that the Third Country has adopted “prudential regulation and ongoing supervision” equivalent to the regulations set forth in the Directive as to management, administration, custodian, valuations, leverage,

- liquidity management etc. This is a subjective standard and may be difficult, if not impossible, to attain.
- ii. The AIFM's Third Country has agreed to reciprocal arrangements as to marketing and grants comparable market access to EU AIFMs.
 - iii. Cooperation agreement in place as to information sharing with regard to market stability.
 - iv. Tax protocol adopted by Third Country that is consistent with the Model Tax Convention of the EU (e.g. as to tax data information sharing.)
2. EU AIFMs marketing EU AIFs to EU investors. This is permitted once the Member State regulator is notified (similar to the "Blue Sky" filing requirements imposed within the United States.)
 3. EU AIFMs marketing non EU AIFs to EU investors. After the three year waiting period, such marketing is permitted to professional clients but only if
 - a. The AIF is domiciled in a country that that has signed a tax protocol agreement that complies with the EU Model Tax Convention, which provides, inter alia, for an effective exchange of information.
 4. Unclear what happens during the 3 year period. No authorization is allowable under the Directive but presumably each Member state will decide on its own.

Can AIFs taking control positions in issuers?

Yes, however control positions in excess of 30% of the voting shares of an issuer require disclosure under the Directive.

What confidential information is required to be disclosed under the Directive?

While reporting is required by various provisions of the Directive, it is silent on the protection of legitimate confidential data.

What is a "professional client"?

A client (in this context, an investor) that meets at least 2 of the following 3 conditions:

1. It has carried out transactions in significant size on the relevant market at an average frequency of 10 such transactions per quarter over the previous 4 quarters.
2. It has a portfolio of financial instruments (including cash) exceeding €500,000.

3. It works for or has worked in the financial sector for at least one year in a professional capacity which requires knowledge of the transaction or services to be rendered.

There are also *per se* professional clients which include banks, regulated financial institutions, pension funds, among others.

What about existing deals?

No information has been made available; on this issue the Directive is silent.

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