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Proposed PE Industry Regulations

On April 29, 2009 the European Commission proposed a Directive on Alternative Investment Fund Managers (the Proposed Directive).¹ The Proposed Directive "lays down the rules for the authorization, ongoing operation and transparency of the managers of alternative investment funds." However, the current iteration of the Proposed Directive raises many questions about the scope and procedural aspects of the regulations.

The Proposed Directive regulates managers of funds, rather than the funds themselves. It does not restrict investment policies but does require disclosure regarding the activities of the funds including annual reports and audited financial statements. Entities must obtain authorization to manage, administer and market funds. Fund managers must comply with ongoing disclosure requirements regarding themselves and the funds they manage. They also must maintain a minimum capital level and strictly monitor and disclose liquidity requirements and other issues relating to the funds they manage. The Proposed Directive makes reference to the "competent authorities" who will be responsible for overseeing the implementation of the regulations, but it is currently unclear who will play this role in each EU Member State.

The Proposed Directive is bound to generate considerable debate among fund managers, investors and politicians. Even before the final version of the Proposed Directive was released, Socialist party leaders, who have been vociferous advocates of the regulations, criticized the draft as being too weak because it regulates only fund managers, rather than the funds themselves. These critics also attacked the Proposed Directive for exempting certain fund managers and for failing to adequately limit leverage exposure or create strong enough capital requirements. On the other side, trade associations

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representing both the hedge fund and private equity industries criticized the Proposed Directive as being a "rush job heavily influenced by politicians seeking to score short-term electoral points." According to Florence Lombard, executive director of the Alternative Investment Management Association, in an interview with EurActiv.com, the political rhetoric "appears designed to satisfy domestic audiences ahead of the forthcoming European elections rather than to secure an effective and sensible solution to identified problems." Also reported on EurActiv.com, Jonathan Russel of the European Private Equity & Venture Capital Association (EVCA) was "deeply concerned that the thresholds set out today punish middle-market companies ... We estimate that around 5,000 portfolio companies will have to comply with costly and unwarranted disclosure rules that go beyond even those required by publicly listed companies."

Following is a brief overview of the main topics regulated by the Proposed Directive. Further changes are anticipated before it is adopted, a process that could take up to two years. Please contact [Guido Panzera](#) or any other member of our CEE Private Equity Team if you have any questions or would like a copy of the Proposed Directive.

Who Is Covered

- The Proposed Directive applies to any legal or natural person established in the European Union (the Community) whose regular business is to manage one or several alternative investment funds domiciled inside or outside the Community.
- An alternative investment fund (AIF) is a collective investment undertaking created for the sole purpose of investing in assets, and is not otherwise regulated under the UCITS Directive.²

Who Is Not Covered

- AIF managers (AIFMs) whose aggregate AIF portfolio has less than €100 million in assets under management or less than €500 million in assets under management if the AIF portfolio is not leveraged and shares cannot be redeemed within five years of the AIF's "date of constitution."
- AIFMs who are not established in the European Union.³
- AIFMs established in the European Union who do not manage or market AIFs in the EU.

What Is Required

- **Authorization** – Entities not authorized under the Proposed Directive may not provide AIF management services to AIFs or market AIFs in the Community. To be authorized, AIFMs must

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demonstrate their qualifications. This process includes providing detailed information on their planned activities, internal operations and AIFs that they manage or intend to manage. Once authorized by a Member State, AIFMs can manage and market AIFs throughout the Community. EU Member States can authorize AIFMs established in non-EU countries to market AIFs to professional investors domiciled in an EU Member State so long as that country has equivalent regulations and supervision.

- **Minimum capital requirements** – AIFMs must maintain capital of at least €125,000. The minimum capital requirement increases by 0.02 percent of the amount that the AIFM's AIF portfolio exceeds €250 million.
- **Valuation** – AIFMs must ensure that all assets and shares of the AIFs in their portfolios are valued by an independent auditor at least once per year. Independent valuations are also required each time shares or units of an AIF are issued or redeemed.
- **Depository** – An independent depository must receive and maintain investment subscriptions from AIF investors in a segregated account, safeguard financial instruments and verify ownership of all assets in which the AIF invests. A depository for a non-EU AIF must meet certain supervision, money laundering and liability standards at least as comprehensive as those of the European Union.

Conduct of Business

- **Delegation** – AIFMs cannot delegate tasks to third parties without meeting certain preconditions and obtaining authorization for each such delegation.
- **Preferential treatment** – AIFMs must ensure that all AIF investors are treated fairly. No investor is permitted to receive preferential treatment unless this preferred status has been disclosed in the AIF's constituent documents.
- **Conflicts of interest** – AIFMs must take all reasonable steps to prevent any conflicts of interest that adversely affect the interests of the AIF and its investors. AIFMs must disclose potential conflicts between the AIFM (including its managers, employees and affiliates) and the AIF investors, as well as potential conflicts among AIF investors.
- **Risk management** – AIFMs investing on behalf of an AIF must implement an appropriate due diligence process. AIFMs must also implement risk management systems and separate risk management and portfolio management operations.

- **Liquidity management** – AIFMs must regularly conduct stress tests, monitor liquidity risks of AIFs and ensure that each AIF has an appropriate redemption policy.
- **Securitization positions** – AIFMs investing in securitized products on behalf of AIFs will have to meet qualitative requirements under measures that will be implemented by the European Commission at a later date.

Transparency

- **Annual reports** – AIFMs must publish annual reports including audited financial statements for each AIF they manage.
- **Pre-investment disclosure** – AIFMs must ensure that investors receive prescribed disclosure on an AIF prior to investing including strategy, service providers, annual reports, liquidity risk and fees.
- **Periodic reporting** – AIFMs must provide periodic reports regarding their trading and details on each AIF they manage including annual reports. AIFMs must also periodically disclose the AIF's risk profile and illiquid or difficult-to-value assets.

Increased Disclosure Requirements

- **Highly leveraged AIFs** – AIFMs are subject to increased disclosure requirements in connection with AIFs whose aggregate leverage exceeded equity capital in two of the prior four quarters. AIFMs must assess AIF leverage on a quarterly basis.
- **Controlling interest** – AIFMs are subject to increased disclosure requirements when an AIF they manage acquires a total of 30 percent or more of the voting rights of a nonlisted company that employs more than 250 people, has an annual turnover in excess of €50 million or has an annual balance sheet total exceeding €43 million.

Marketing

- Authorized AIFMs can market only to professional investors in the Community, unless otherwise permitted by their home EU Member State. "Professional investors" must meet enumerated criteria set forth in the Proposed Directive, but they are generally regulated financial market participants with sufficient experience and expertise to make their own investment decisions and weigh potential risks.
- Authorized AIFMs can market AIFs to professional investors throughout the Community so long as

they submit relevant disclosure materials to the "competent authorities" of their home Member State. These materials include a notification letter, a prospectus and certain other prescribed information.

- AIFMs can market non-EU-domiciled AIFs to professional investors domiciled in a Member State only if that country has an agreement with the Member State that is fully compliant with the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention.

Implementation

- The Commission may adopt and implement additional measures that amend and supplement "nonessential" elements of the Proposed Directive. The Commission has not stated the deadline date by which Member States must enact laws and regulations necessary to comply with the Proposed Directive.

¹ A directive is a legislative act of the European Union (the Community) requiring Member States to implement measures in their national law within a set time period. If a Member State fails to implement the required legislation within that time period or does not otherwise comply with the directive, the European Commission may initiate legal action against the Member State in the European Court of Justice.

² EU Directive, recast in 2009, regulating Undertakings for Collective Investment in Transferable Securities.

³ Note, however, that the Proposed Directive ambiguously states that any entities that are not authorized or are not covered by the Proposed Directive cannot provide AIF management services in the European Union.

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