

REGULATION OF EU PRIVATE EQUITY AND HEDGE FUND MANAGERS AHEAD – BUT NOT ANY TIME SOON

May 1, 2009

To Our Clients and Friends:

On April 30, 2009, the European Commission — as the “first mover” to address a consensus reached by the G20 leaders over the need for regulation of the alternative fund sector — unveiled its keenly awaited draft of a Directive on Alternative Investment Fund Managers (“AIF Managers”). Once considered and approved by the European Council and the European Parliament, the Directive will enter into force, but likely not before 2011.

The Directive:

- establishes a comprehensive regulatory and supervisory framework for managers and administrators of Alternative Investment Funds (“AIF”) (all funds not regulated under the UCITS Directive) – including hedge funds, private equity funds, funds of hedge funds, real estate funds, infrastructure funds and commodity funds;
- is mainly driven by the European Commission’s aim to get control over what it perceives as macro-prudential (systemic) risks in unregulated fund markets;
- regulates all AIF Managers established in the EU with assets under management greater than €100 million; for AIF that do not employ leverage and do not grant investors redemption rights during a five-year lock-up period, the regulatory threshold for assets under management by the AIF Manager is €500 million. The European Commission estimates that, as proposed, 30% of hedge fund managers managing nearly 90% of assets of EU-domiciled hedge funds will be covered; half of other types of AIF Managers, such as private equity fund managers, will be picked up;
- applies to the AIF Managers specified above that provide management services to one or more AIFs, *whether or not* the AIF for which they provide management services is domiciled inside or outside the EU;
- provides that only authorized and registered EU-domiciled AIF Managers can provide management services and market AIF solely to “professional investors” in the EU;
- does *not regulate* any AIF itself, its fees or fund investment objectives;

- does *not apply* to EU-domiciled AIF Managers that do not provide management services to an EU-domiciled AIF and do not market AIF within the territory of the European Community.

PURPOSE OF THE DIRECTIVE

The Directive's objective is to harmonize across the EU the regulation and supervision of AIF Managers through authorization and registration requirements. Other key objectives are investor protection, public accountability for AIF holding controlling stakes in listed or non-listed EU-domiciled companies and developing a single European market for AIF.

KEY PROVISIONS

Authorization and Operating Conditions. Any EU-domiciled AIF Manager that meets the regulatory thresholds of €100 million or, alternatively, €500 million would need to:

- apply for authorization and registration with the competent authority in its home Member State;
- provide detailed information to the competent authority about the planned activity of the AIF Manager, the identity and characteristics of the managed AIF, the governance of the AIF Managers (including arrangements for the delegation of management services), valuation and safe-keeping of assets (which must be performed by an unaffiliated third party), auditors and regulatory reporting systems;
- maintain a minimum capital requirement of at least €125,000 (additional capital is required if the value of the assets under management exceeds €250 million);
- conduct its business in a prudent manner;
- maintain a system to prevent conflicts of interest between the AIF and its investors and implement procedures for appropriate segregation of duties;
- install risk management procedures and review them at least annually;
- employ an appropriate liquidity management system;
- ensure that for each AIF managed by the AIF Manager an independent valuator and depositary is appointed;
- make available an annual report to investors in the AIF and the competent authority, including at least an income statement and balance sheet and a report on the activities of the financial year;

- comply with detailed and specified disclosure requirements for the offering documents and make specific periodic disclosures to investors (*e.g.*, percentage of assets that are illiquid); and
- report on a regular basis to the competent authority information on the principal market and instruments in which the AIF Manager trades, its principal exposures, performance data and risk concentration.

Marketing of AIF to “Professional Investors.” Under the final draft Directive, authorization as an AIF Manager will entitle the manager to market shares or units of AIF only to “professional investors” in its home Member State. The Directive does not address authority to market AIF to retail investors, but specifically states that Member States may permit marketing of AIF to retail investors within their territory and can, for that purpose, provide for additional regulatory safeguards and impose stricter requirements on the AIF Manager or the AIF. It is noted that some open-end real estate and other types of funds can be marketed to retail investors in some Member States already. “Marketing” as used in the Directive is broadly defined to include the public offering and any other placement of units or shares in an AIF to investors domiciled in the EU, regardless of at whose initiative the offer or placement takes places. Thus, it appears that the so-called “passive freedom of services doctrine” permitting unsolicited marketing and sales would be inapplicable to AIF.

Disclosure of Controlling Influence over a Portfolio Company. The proposed Directive provides that Member States need to ensure that (i) when an AIF Manager managing one or more AIF which individually or in aggregate is in a position to exercise 30% or more of the voting rights of a non-listed EU-domiciled company (or has an agreement with other AIF Managers), such AIF Manager notifies the company and all other shareholders, and (ii) when an AIF Manager acquires 30% or more of the voting rights of any EU-domiciled issuer or non-listed company, it must disclose to the company, its shareholders and its employees specific information, including the plans for the company. In case of a delisting of a publicly traded issuer following an acquisition of 30% of the voting rights, the obligations under the EU Transparency Directive have to be complied with for a period of two years following the delisting.

The Directive provides an exception for a non-listed company which is a small or medium enterprise that employs fewer than 250 persons, has an annual turnover not exceeding €50 million and/or an annual balance sheet not exceeding €43 million.

Delegation of Functions. An AIF Manager may not delegate any of its functions to third parties without the prior authorization of the competent authority of the home Member State. If delegation concerns portfolio management or risk management, the third party must be authorized as an AIF Manager (to manage an AIF of the same type) under the Directive.

Moreover, the third party delegate may not sub-delegate any of the functions delegated to it by the AIF Manager. This requirement could result in changes to delegation arrangements already in place. Also, the delegation of administrative tasks to an entity established in a non-EU country as well as the delegation of depositary tasks in respect of AIF domiciled in a third country would, under the proposed Directive, be subject to specific requirements, including that necessary safeguards are in place.

Passporting to other Member States. The authorization granted to the AIF Manager in its home Member State to provide management services and/or market AIF to professional investors is valid for all Member States. Under the passporting rules provided for in the proposed Directive, the AIF Manager can provide management services for an AIF domiciled in another Member State and market the units or shares of an AIF it manages in another Member State.

Application to Non-EU (Third) Countries. An EU-authorized AIF Manager may only market shares or units of an AIF domiciled in a third country to professional investors (but not retail investors) domiciled in a Member State if the third country has signed an agreement with this Member State that fully complies with the standards for tax transparency in Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information in tax matters.

Furthermore, Member States may authorize non-listed EU-domiciled AIF Managers to market AIF units or shares to professional investors in the EU only if the following conditions, among others, are met by the country of domicile of the non-EU AIF Manager:

- the third country's legislation regarding prudential regulation and ongoing supervision is equivalent to the provisions of the Directive;
- the third country grants EU AIF Managers comparable market access;
- a cooperation agreement between the competent authority of that Member State and the supervisor of the AIF Manager exists, ensuring efficient information exchange; and
- the third country has signed an agreement with the Member State that fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information in tax matters.

No Present Change for Non-EU AIF Managers. In light of the requirements noted above, the Commission must adopt implementing measures establishing general equivalence criteria and ensuring an efficient information exchange. Therefore, the right under the Directive to market AIF domiciled in third countries to EU professional investors will only become effective three years after the period when every EU Member State is required to enact the

Directive. Until then, offshore AIF advised by non-EU managers can continue to be marketed to professional investors in those EU Member States which currently allow it under national law.

OUTLOOK

The proposed Directive has spawned strong reactions by various constituencies. For example, the European alternative fund management community is already challenging many aspects of the proposal and it can be expected that non-EU fund organizations similarly will launch vigorous responses. The proposal, for example, does not appear to take into account the particular governance structures of European-listed permanent capital vehicles. More controversy, lobbying and debate is sure to come as the approval process unfolds. We will keep you informed about future developments.

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This memorandum is a brief summary of the issues addressed herein and is not intended to be legal advice. Please do not hesitate to contact us with any questions.

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