PROPOSED EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUND MANAGERS: IMPACT ON NON-EU-BASED FUND MANAGERS

The European Union is currently considering proposed legislation that would impose new and potentially burdensome regulation on managers of hedge funds, private equity funds and other alternative investment funds and limit the extent to which such funds can be marketed to investors within the European Union (the “EU”). The proposal1 (the “AIFM Proposal”) is of significance to non-EU-based fund managers because it would substantially limit the marketing of their alternative investment funds to investors in the EU.

WHAT IS THE SCOPE OF THE PROPOSAL?

The AIFM Proposal would regulate EU-based managers who, directly or indirectly, manage alternative investment funds (“AIFs”) with cumulative assets of EUR 100 million or more (or EUR 500 million or more if the funds under management are not leveraged and have a 5 year lock-in period for their investors) and, in addition, the marketing of AIFs to investors in the EU. For this purpose, AIFs include hedge funds, private equity funds and any other form of investment fund, whether open or closed-ended and wherever established but exclude EU retail funds established under the EU Directive on Undertakings for Collective Investment in Transferable Securities (UCITS funds). Since the Proposal is aimed at vehicles for collective investment, it does not apply to the management of individual investor portfolios such as pension funds, sovereign wealth funds, endowments or other assets held on own account.

WHAT ARE THE MAIN PROVISIONS OF THE PROPOSAL?

The AIFM Proposal provides for the authorization, prudential regulation and on-going supervision of managers of AIFs. It also substantially restricts the marketing to EU-based investors of AIFs established outside the EU.

Under the Proposal, only fund managers authorized in a Member State would be permitted to manage an AIF in the EU or market an AIF to EU investors2. Authorized managers would be subject to initial and on-going capital requirements, operational requirements relating to their management of AIFs (in particular relating to the management of conflicts, risk and liquidity and the delegation of management functions), limitations on the amount of leverage which could be employed by AIFs under their management and organizational requirements relating to those AIFs (for instance, the appointment of a depositary and independent valuer in relation to those funds).

The intended effect of a number of provisions in the AIFM Proposal is unclear, in particular the restrictions imposed on the marketing of AIFs.

---

2 Credit institutions are outside the scope of the Proposal but the intended effect of this exclusion in relation to the marketing of AIFs by credit institutions is not clear.
The Proposal appears aimed at substantially limiting the marketing in the EU of AIFs that do not have an authorized fund manager. Since it would be very difficult for non-EU-based fund managers to become authorized, in practice this would mean that non-EU-based fund managers would be unable to market their AIFs within the EU even if they can presently do so under current marketing or private placement exemptions in individual Member States.

The marketing of non-EU-based AIFs that do have an authorized fund manager would be subject to additional restrictions following a transitional period of three years from the Proposal being implemented. At the expiry of that period, those funds could be marketed to an investor in the EU only if there were to be in place between the country in which the fund is established and the EU Member State in which the investor is located, a tax information exchange agreement complying with OECD model standards. Further, AIFs could only be marketed within the EU to professional investors, although it would be open to individual Member States to permit AIFs to be marketed to retail investors within their jurisdictions. Any marketing of an AIF would require the prior approval of the regulator in the home Member State of the AIF’s authorized manager. Such approval would allow marketing of the AIF to professional investors across all EU Member States (although, for a non-EU-based AIF, this would only be permitted at the expiry of a period of three years from implementation of the Proposal and would be subject to appropriate tax information exchange agreements being in place with each jurisdiction into which the fund is marketed).

In addition, the AIFM Proposal imposes transparency requirements on managers of AIFs relating to the preparation of annual audited accounts, the disclosure to investors prior to investment of information relating to a fund and its organization and the periodic disclosure to investors of risk and liquidity information. A manager of an AIF will also be required to disclose to companies in which its managed AIF holds a controlling interest (i.e. 30% or more of the voting rights) information regarding its interest and its policies and plans relating to the company.

**WHAT ARE THE CONCERNS FOR NON-EU-BASED FUND MANAGERS?**

Non-EU-based fund managers are likely to be concerned principally with the marketing restrictions in the AIFM Proposal. The Proposal would seemingly substantially restrict non-EU-based fund managers from marketing their AIFs to investors in the EU. Marketing, for the purposes of the Proposal, includes offering or placing a fund interest in response to a solicitation from an investor. As a result, non-EU-based fund managers would be unable to raise funds for their managed AIFs from EU investors even if contact were to be initiated by investors.

Since the marketing restrictions in the AIFM Proposal would seemingly apply in relation to sales of existing interests in AIFs, as well as in relation to capital raisings, they would limit secondary market transactions in interests in AIFs. Non-EU-based sellers of interests in AIFs would be unable to market those interests to potential EU purchasers. This may be of particular relevance in the context of the secondary market in private equity fund interests.

The Proposal contemplates that, following the three-year transitional period from its implementation, a non-EU-based manager would be able to become authorized to market an AIF to EU investors subject to compliance with certain conditions. The conditions, which would likely be very difficult to meet and would effectively substantially limit this option, include the following:

- the country in which the non-EU-based manager is based being assessed by the EU Commission as having effectively enforced legislation providing for prudential
regulation and on-going supervision equivalent to that provided for under the AIFM Proposal;

- that country being assessed by the EU Commission as granting EU authorized fund managers effective market access comparable to that granted in the EU under the AIFM Proposal to fund managers from that country;

- an information exchange co-operation agreement for regulatory supervision purposes being in place between the regulator of the non-EU-based manager seeking authorization and the regulator in the EU Member State in which authorization is sought; and

- the country in which the non-EU-based manager is based having an effective OECD model tax information exchange agreement in place with the EU Member State in which authorization is sought.

The AIFM Proposal does offer benefits to investors in AIFs managed by EU-based managers. Non-EU-based investors in these AIFs should benefit from the disclosure and operational requirements imposed on managers by the Proposal. However, costs incurred by some such funds and, thus, borne by investors may increase in consequence of such requirements, in particular the capital requirements for managers and the requirements for a separate risk management function and for the appointment of a depositary and independent valuer.

**WILL THE PROPOSAL BECOME LAW?**

The AIFM Proposal must now progress through the EU’s legislative process. Following the summer break, the Proposal will be reviewed by the European Parliament, with Parliament’s Economic and Monetary Affairs Committee (ECON) taking the lead, and the Legal Affairs Committee (JURI) playing a secondary role. Once the Proposal has been finalized and approved, it will come into force as a “Directive” at the EU level, and will then need to be supplemented through technical implementing legislation made by the European Commission.

The European Parliament, composed of directly elected members from each of the Member States, has for some time been calling for reform of the European financial system, in the form of tougher regulation and increased transparency. It views the EU Commission’s response to the global financial crisis as inadequate and the current proposal as belated. With this in mind, the European Parliament is likely to call for the Commission to incorporate even more stringent measures into the Directive.

**THE OPPORTUNITY FOR INFLUENCING THE PROPOSAL**

Opportunities for seeking to influence the outcome and impact of the Proposal will arise during the course of the legislative process, not only in relation to the substantive content and scope of the Directive, but also in relation to the technical implementing legislation which will need to be made by the EU Commission under the Directive. Since the Proposal is in many respects unclear, and its intended effect uncertain, there is potential for change to be realized by addressing detailed drafting issues in the Proposal, in relation to which political views of legislators may be less entrenched, as well as high-level policy issues.

**WHERE COVINGTON CAN ASSIST**

With years of public-sector leadership in Europe on legislative initiatives and extensive private-sector experience in the funds industry, Covington has a unique combination of expertise, relationships and political insight necessary to assist non-EU-based fund managers in relation to the AIFM Proposal.
Lawyers in our Financial Services Regulatory and Funds practice in London have been actively monitoring the AIFM Proposal. We are well-placed to assist clients in understanding the potential impact of the Proposal and to track substantive developments as the Proposal progresses through the legislative process. Moreover, with experience involving more than 900 investment funds located in over 30 jurisdictions worldwide, lawyers in our trans-Atlantic funds practice understand the industry and know the issues of most importance to fund managers and investors. Covington’s multidisciplinary approach would bring together this industry and regulatory expertise with the skills and experience of our Government Affairs group in helping to develop and execute an efficient strategy.

For nearly two decades, Covington’s European Government Affairs team has been among the leading law firms helping to ensure that industry’s voice is heard in the European Union’s legislative process. We understand how the relevant EU institutions and committees operate and interoperate, and also appreciate the role that key Members of Parliament play in the legislative process. Members of Covington’s European Government Affairs group have extensive and direct experience with the ECON and JURI Committees that will be instrumental in finalizing the AIFM Proposal, as well as with the European Peoples Party (EPP), a member of which will play the important role of rapporteur in the ECON Committee. Our European Government Affairs team is headed by Senior European Policy Advisor Wim van Velzen, a former leading member of the European Parliament and former vice president of the EPP and the EPP-European Democrats Group, Parliament’s largest political group.

If you have any questions concerning the material discussed in this client advisory, please contact the following practice group members:

**Financial Services Regulatory and Funds**

Simon Currie +44.(0)20.7067.2011 scurrie@cov.com  
Hilary Prescott +44.(0)20.7067.2008 hprescott@cov.com  
Tim Clark +1.212.841.1089 tclark@cov.com

**European Government Affairs**

Lisa Peets +44.(0)20.7067.2031 lpeets@cov.com  
Wim van Velzen +32.2.549.5230 wvanvelzen@cov.com

This information is not intended as legal advice, which may often turn on specific facts. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

Covington & Burling LLP is one of the world’s preeminent law firms known for handling sensitive and important client matters. This promotional communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to unsubscribe@cov.com if you do not wish to receive future emails or electronic alerts. Covington & Burling LLP is located at 265 Strand, London WC2R 1BH.

© 2009 Covington & Burling LLP. All rights reserved.