

**Authors:****Edward G. Eisert**

edward.eisert@klgates.com  
+1.212.536.3905

**Philip J. Morgan**

philip.morgan@klgates.com  
+44.(0)20.7360.8123

**Sarah E. Connolly**

sarah.connolly@klgates.com  
+1.202.778.9120

**Richard A. Dollimore**

richard.dollimore@klgates.com  
+971.4.427.2705

**Jarrold R. Melson**

jarrold.melson@klgates.com  
+1.202.778.9349

K&L Gates includes lawyers practicing out of 36 offices located in North America, Europe, Asia and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information, visit [www.klgates.com](http://www.klgates.com).

## European Parliament Approves Alternative Investment Fund Managers Directive

### I. Introduction

#### A. Overview

On November 11, 2010, the European Parliament (the “**Parliament**”) of the European Union (the “**EU**”) approved the “Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers” (the “**Directive**”). First proposed in April 2009 in response to the financial crises, the Directive seeks to provide a harmonized EU regulatory framework for the supervision and operation of alternative investment fund managers (“**Managers**”) <sup>1</sup> and is expected to have far-reaching consequences for the funds industry both in the EU and elsewhere. <sup>2</sup> References are to articles of the Directive.

Broadly, the Directive will apply to: (i) Managers with a registered office in the EU (“**EU Managers**”); and (ii) all other Managers (“**Non-EU Managers**”) that manage and/or market alternative investment funds (“**Funds**”) in the EU (Art. 4(1)(m), (ac)). For the purposes of the Directive, “Funds” include hedge funds, private equity funds, real estate funds, infrastructure funds, mutual funds domiciled and registered in the United States, and all other collective investment undertakings that are not compliant with the EU Undertakings for Collective Investments in Transferable Securities Directive (“**UCITS**”) (Art. 4(1)(b)).

The Directive envisages the phased introduction of an EU passport system for the cross-border marketing of Funds to professional investors <sup>3</sup> in the EU. The passport will be available initially only to EU Managers of EU Funds. EU legislators <sup>4</sup> agreed, after prolonged negotiations, that the passport may be extended to Non-EU Managers and EU Managers of Non-EU Funds two years later, subject to the recommendation of the European Securities Market Authority (“**ESMA**”) <sup>5</sup> and the adoption of delegated acts by the European Commission of the EU (the “**Commission**”). The Directive contemplates that the existing private placement regimes of individual Member States (the “**Private Placement Exemptions**”) will continue to operate alongside the new passport system for a period of time but, ultimately, may be eliminated. Under the passport system, Managers will be authorized to market Funds only to professional investors, although the Directive authorizes Member States to permit marketing to other investors under their Private Placement Exemptions (*see* III.C.1).

#### B. Implementation of Dual System for Marketing to Professional Investors

The Directive proposes the implementation of a passport system for the marketing and managing of Funds in the EU in accordance with the timeline on the following page.

Date	Directive Provisions
The Directive enters into force (expected to be Q1 or Q2 of 2011)	<ul style="list-style-type: none"> <li>Member States have two years from this date to “transpose” the Directive into national legislation (<i>i.e.</i>, to adopt laws implementing the Directive at the national level).<sup>1</sup></li> <li>EU and Non-EU Managers may continue to operate under existing private placement regimes in effect in the various Member States. No new requirements are imposed by the Directive.</li> </ul>
<p><b>“Directive Implementation Date”</b> Two years after the Directive enters into force (expected to be early 2013)</p>	<ul style="list-style-type: none"> <li>The Directive has been transposed into national legislation.</li> <li>The passport system is introduced only for EU Managers marketing or managing EU-domiciled Funds (“<b>EU Funds</b>”). These Managers must comply in full with the Directive.</li> <li>The Private Placement Exemptions apply to all other Managers, subject to requirements under the Directive described below (<i>see</i> III.A.2(ii), III.B.2(ii)).<sup>2</sup></li> </ul>
<p><b>“Non-EU Passport System Implementation Date”</b> Two years after the Directive Implementation Date (expected to be Q1 or Q2 of 2015)</p>	<ul style="list-style-type: none"> <li>If recommended by ESMA, the passport system will be introduced for EU Managers marketing Funds domiciled outside the EU (“<b>Non-EU Funds</b>”) and for Non-EU Managers marketing EU or Non-EU Funds.</li> <li>EU Managers marketing Non-EU Funds, and Non-EU Managers, will be permitted to continue to rely on the Private Placement Exemptions instead of the passport system, subject to the Directive requirements discussed below (<i>see</i> III.A.2(ii), III.B.2(ii)).<sup>7</sup></li> <li>Non-EU Managers managing EU Funds must be authorized and comply in full with the Directive.</li> </ul>
Approximately three years after the Non-EU Passport System Implementation Date (expected to be mid- 2018)	<ul style="list-style-type: none"> <li>ESMA must review the Private Placement Exemptions.</li> <li>If ESMA recommends abolishing the Private Placement Exemptions, Commission may adopt acts specifying the termination date for the Private Placement Exemptions.</li> </ul>
<p><b>“Private Placement Termination Date”</b> (expect to be no earlier than mid-2018)</p>	<ul style="list-style-type: none"> <li>Private Placement Exemptions cease to be available in the EU (subject to the recommendation of ESMA and the adoption of Commission acts).</li> <li>If Private Placement Exemptions are abolished, all Managers are required to use the passport system to market Funds in the EU and must comply in full with the Directive from this date.</li> </ul>

<sup>1</sup> It is possible that Member States may not implement the Directive simultaneously and, thus, that there may be a “rolling” implementation schedule.

<sup>2</sup> In these circumstances, Member States may impose stricter rules on the Manager in respect of the marketing of units or shares of Funds to investors in their territory.

## II. Scope of Coverage of the Directive; Authorization

### A. Scope of Coverage

Most of the provisions of the Directive will apply only to those Managers that manage portfolios of Funds whose assets under management exceed certain thresholds.<sup>6</sup> The thresholds apply irrespective of the number of Funds that the Manager manages or the amount of assets of the Manager itself (Art. 3(2)(a)).

For Managers managing Funds that do not use “leverage” and that have at least a five-year lock-up period for investors (as is the case with many funds that are commonly referred to as “venture capital funds”), the threshold is €500 million (Art. 3(2)(b)). “Leverage” is defined as any method by which the Manager increases the exposure of a Fund and includes borrowing of cash or securities as well as leverage embedded in derivatives positions (Art. 4(1)(w)). For all other Managers, the threshold is €100 million, including any assets acquired by Funds through the use of leverage (Art. 3(2)(a)). It is unclear whether Managers managing both Funds that use leverage and Funds that do not use leverage and have a five-year lock-up will be required to aggregate the assets under management of both types of Funds. This is expected to be clarified in “Level 2” measures that the Commission will adopt to implement the Directive and keep technical aspects of the Directive up to date.

Managers that do not exceed the threshold(s) will be required to register with the relevant authorities of their home Member States and provide certain information to allow such authorities to monitor systemic risk effectively (Art. 3(3)). Such Managers will not be subject to any other requirements under the Directive as their activities are deemed to be unlikely to have “significant consequences for financial stability” (Preamble par. 13). These Managers, however, will not have any rights under the Directive unless they opt-in (for example, to be able to take advantage of the passport system to market to professional investors across the EU), in which case they will be subject to all of the requirements of the Directive, *i.e.*, a “light-touch” opt-in regime will be not available (Art. 3(4)).

### B. Authorization

The Directive contemplates that, by the Private Placement Termination Date, all Managers that

either manage EU Funds or market any Fund in the EU will be authorized under the Directive by the relevant Member State authorities as set forth below:

- As of the Directive Implementation Date, EU Managers that manage any Fund will be required to be authorized under the Directive by their home Member State (Art. 6(1)).
- As of the Directive Implementation Date, EU Managers that market any Fund in the EU will be required to be authorized under the Directive by their home Member State (Art. 31-33).
- As of the Non-EU Passport System Implementation Date, Non-EU Managers that market any Fund in the EU pursuant to the passport system must be authorized by their “Member State of reference” (which is, broadly, the Member State with which the Manager has the greatest connection) (Art. 37, Art. 38(3), Art. 39(3), Art. 63bis).
- As of the Non-EU Passport System Implementation Date, Non-EU Managers that manage any EU Fund must be authorized by their Member State of reference, regardless of whether they market such Funds in the EU (Art. 37, Art. 63bis).
- As of the Private Placement Termination Date, all Non-EU Managers that market any Fund in the EU must be authorized by their Member State of reference. Until such date, Non-EU Managers that market any Fund in the EU solely under the Private Placement Exemptions (except where the Fund is an EU Fund that they manage) will be exempt from the authorization requirements under the Directive (unless separately required under the particular Private Placement Exemption applicable in the relevant Member State) (Art. 40, Art. 63ter).

To obtain authorization, a Manager will be required to show that it is suitably qualified to provide Fund management services. Among other things, it will be required to provide detailed information on the risk profile and other characteristics of the Funds to be managed and information about how the Manager intends to comply with the Directive requirements regarding, among other things,

governance, risk management, remuneration, valuation, and safe-keeping of assets (Art. 7(2), (3)).

The authorized Manager will be responsible for ensuring compliance with all of the requirements of the Directive with respect to each Fund that it manages and/or markets. Notably, a Fund can have only one authorized Manager under the Directive. However, if multiple entities provide portfolio or risk management services to the same Fund, under the Directive's broad definition of "Manager," each such entity would come within this definition (Art. 4(1)(c), (x)). In these circumstances, one entity must be identified as the Manager for the purposes of the Directive, although it is unclear how such Manager would be identified (*e.g.*, may the Fund itself designate the primary Manager?). The Manager would be required to appoint any other entities that come within the Manager definition as its delegates in order for such entities to be authorized to provide management or risk management services to the Fund (Art. 20). However, Managers will be permitted to delegate their management responsibilities only if certain conditions are satisfied and they will remain liable to the Funds' investors for the activities of their delegates. Further, it is currently unclear how the single Manager requirement will be applied in practice, for example, with respect to a Fund that is managed by a Non-EU Manager and is sub-advised by its subsidiary in the EU, or that is managed by a Manager that relies upon personnel employed or supervised by another Manager for portfolio management, research or other services.

In addition, in circumstances described above where Non-EU Managers need to be authorized under the Directive, they will be required to have a legal representative in their Member State of reference (Art. 37(3)). The legal representative must be a natural person domiciled in the EU or a legal person, *i.e.*, non-natural person, with its registered office in the EU, and will serve as the contact point of the Manager in the EU (Art. 4(1)(v), Art. 37(3)). The legal representative will be required, together with the Manager, to perform the compliance function relating to the management and/or marketing activities performed by the Manager under the Directive (Art. 37(3)). The legal representative is required to "at least be sufficiently equipped to perform [this] compliance function," but the Directive does not address the extent of the legal

representative's liability in the event of the Manager's noncompliance with the Directive (Art. 37(7)(c)). Given this lack of clarity, as well as the practical difficulties in monitoring an offshore Manager, it is unclear who, other than an affiliate or EU-based branch of a Manager, would be willing to serve as the Manager's legal representative.

### III. Basic Requirements of the Directive

#### A. Regulation of EU Managers

##### 1. *Managing EU Funds and Marketing EU Funds to Professional Investors*

As of the Directive Implementation Date, EU Managers that wish to market EU Funds to professional investors in the EU are eligible for passporting and will be required to comply with all of the Directive's provisions (Art. 31(1)). The marketing of Funds across EU borders will be subject to a notification procedure under which certain information will be provided to the regulator in the home Member State and passed on to each host Member State regulator (Art. 32).

As of the same date, EU Managers also will be able to "passport" their management services into other Member States, subject to a notification procedure, although similar passporting rights already are available under the EU Markets in Financial Instruments Directive ("**MiFID**") for Managers that are currently within the scope of MiFID (Art. 33).<sup>7</sup>

According to the Commission's introductory notes to the Directive, EU Managers that are authorized or licensed under MiFID should not be required to obtain separate authorization in order to provide investment services in respect of EU Funds (Preamble par. 7). However, such Managers will be able to market EU Funds to investors in the EU only if, and to the extent that, they can be marketed in accordance with the Directive.

##### 2. *Marketing Non-EU Funds to Professional Investors*

###### (i) *Passporting*

If ESMA recommends the introduction of the passport system with respect to Non-EU Funds, EU Managers may begin using a passport to market Non-EU Funds in the EU as of the Non-EU

Passport System Implementation Date, provided that:

- the Manager complies with all of the requirements of the Directive, except Chapter VI (applicable only to EU Managers marketing and managing EU Funds in the EU);
- an appropriate co-operation arrangement for the efficient exchange of information has been entered into between the competent authority of the Manager's home jurisdiction and the supervisory authority of the third country where the Non-EU Fund is established (the **"Cooperation Condition"**);
- the third country where the Non-EU Fund is established is not listed as a Non-Cooperative Country and Territory by the Financial Action Task Force on anti-money laundering and terrorist financing (the **"AML Condition"**); and
- the Non-EU country in which the Fund is established must have entered into an agreement based on Article 26 of the OECD Model Tax Convention with the Manager's home EU Member State and each other Member State in whose territory the Fund is proposed to be marketed for the effective exchange of information on tax matters (the **"Tax Treaty Condition"**) (Art. 35(2)).

(ii) *Private Placement Exemptions*

Instead of using a passport, an EU Manager may take advantage of the Private Placement Exemptions available in individual Member States where the Fund is marketed. Before the Directive Implementation Date, the Directive does not impose any new requirements upon an EU Manager that continues to rely on such exemptions. As of the Directive Implementation Date, however, the EU Manager will be required to comply with all of the provisions of the Directive, except the depositary requirements in respect of Non-EU Funds (Art. 36(1)(a)). In addition, the country where the Fund is established must satisfy the Cooperation Condition and the AML Condition, although it will not be required to satisfy the Tax Treaty Condition (Art. 36(1)). If ESMA recommends the abolishment of the Private Placement Exemptions, EU Managers will be required to use a passport and comply with

all of the foregoing requirements after the Private Placement Termination Date.

## B. Regulation of Non-EU Managers

The Directive envisages that regulators in Member States will allow Non-EU Managers to manage EU Funds and/or to market Funds to professional investors within the EU, subject to specific conditions. Noncompliance with a Directive provision is permitted in "very exceptional circumstances" if the Non-EU Manager can demonstrate that it is "impossible" to comply with that provision in combination with a mandatory rule of the Manager's, and/or its Non-EU Fund's, national law (Preamble par. 42). The relevant national law must provide an "equivalent rule having the same regulatory purpose and offering the same level of protection to the investors of the relevant [Fund]," and the Manager and/or the Fund must comply with that rule (Art. 37(2)(ii)). Thus, Non-EU Managers would need to satisfy a very high threshold to be exempted from any of the Directive's requirements.

### I. *Managing EU Funds*

As of the Non-EU Passport Implementation Date, a Non-EU Manager that manages EU Funds will be required to be authorized and comply with all of the Directive's requirements, except for Chapter VI (Art. 6(1), Art. 37(2)). This requirement will apply regardless of whether the Non-EU Manager markets the EU Funds in the EU.

Non-EU Managers will be granted authorization only if (i) they have a legal representative established in their Member State of reference (*see* II.B); (ii) the Cooperation Condition is satisfied as between the authorities of the Non-EU Manager's home jurisdiction and the Member State of reference and, if different, the Member State where the EU Fund is established; (iii) the AML Condition is satisfied in respect of the Non-EU Manager's home jurisdiction; (iv) the "effective exercise by the competent [Member State] authorities of their supervisory functions under the Directive is not prevented by the laws, regulations or administrative provisions of [the Non-EU Manager's home jurisdiction], nor by the limitations in the supervisory and investigatory powers of the ... supervisory authorities" of the Non-EU Manager's home jurisdiction; and (v) the Non-EU Manager's home jurisdiction satisfies the Tax Treaty Condition

in respect of the Non-EU Manager's Member State of reference (Art. 37(7)).<sup>8</sup>

## 2. *Marketing Funds in the EU*

As noted above, the Directive contemplates that the passport system will be introduced for Non-EU Managers as of the Non-EU Passport Implementation Date. If the passport system is introduced, the Directive provides for a dual system of passporting and reliance on Private Placement Exemptions during a transition period between the Non-EU Passport Implementation Date and the Private Placement Termination Date. The specific conditions and requirements that must be satisfied will depend on which route is adopted by the Manager.

### (i) *Passporting*

The passport system will enable a Non-EU Manager to market EU and Non-EU Funds to professional investors across the EU without being subject to the particular registration and marketing requirements of each Member State in which the Funds will be marketed. However, to obtain a passport, a Non-EU Manager will be required to comply with all of the provisions of the Directive (except Chapter VI), which may prove too burdensome for some Non-EU Managers (Art. 38, 39). In particular, U.S. Managers may find several requirements of the Directive to be more onerous than those under the U.S. federal securities laws (*e.g.*, provisions governing remuneration, leverage, valuation and capital requirements).

In addition, Non-EU Managers will be granted authorization to market Funds with a passport only if: (i) the Cooperation Condition is satisfied as between the authorities of the Non-EU Manager's home jurisdiction and the Member State of reference; (ii) the AML Condition is satisfied in respect of the Non-EU Manager's home jurisdiction; (iii) the effective exercise by the competent Member State authorities of their supervisory functions under the Directive is not prevented by the laws, regulations or administrative provisions of the Non-EU Manager's home jurisdiction; (iv) the Non-EU Manager's home jurisdiction satisfies the Tax Treaty Condition in respect of the Non-EU Manager's Member State of reference; and (v) the Non-EU Manager has a legal representative established in its Member State of reference (*see* II.B) (Art. 37(7)). The first four of these conditions also must be

satisfied by the Non-EU Fund's country of establishment (Art. 39(2)).

### (ii) *Private Placement Exemptions*

A Non-EU Manager may market both EU Funds and Non-EU Funds in accordance with the existing Private Placement Exemptions available in each Member State where such Funds are to be marketed until the Private Placement Termination Date (or longer, depending on ESMA's recommendation with respect to the abolishment of Private Placement Exemptions). However, as of the Directive Implementation Date, the Manager must comply with the relevant Private Placement Exemptions as well as the transparency requirements of the Directive, *i.e.*, Article 22 (Annual reports), Article 23 (Disclosure to investors) and Article 24 (Reporting obligations to competent authorities) and, in relation only to Funds that take control of non-listed companies (such as certain funds commonly referred to as private equity funds), Articles 26 to 30 (relating to notification, disclosure and asset stripping) (*see* III.C.2 and 3 below for further details) (Art. 40(1)).

In addition to the transparency requirements, the Cooperation Condition with the Member State where the Fund is to be marketed and the AML Condition must be satisfied with respect to the Non-EU Manager's country of establishment, and, if a Non-EU Fund is to be marketed, with respect to the Non-EU Fund's country of establishment (Art. 40(1)).

## 3. *"Passive" Marketing*

The Directive is not intended to affect existing practices under which a professional investor domiciled in the EU invests, at its own initiative, in Non-EU Funds managed by a Non-EU Manager, provided such Manager does not market to such investors (Preamble par. 44). The Directive defines "marketing" as any direct or indirect offering or placement *at the initiative of the Manager* (Art. 4(1)(y)). Accordingly, even after the Directive is fully implemented, Non-EU Managers should be able to continue receiving unsolicited calls and subscription requests from EU professional investors without being subject to the Directive. It is unclear, however, whether the Directive would apply if, for instance, a Non-EU Manager sends marketing materials to EU investors in response to a RFP. Even if such activity follows from investor-

initiated contact, in practice it may prove difficult to distinguish “active” from “passive” marketing, absent further clarification from the Commission.

### C. Requirements of the Directive of General Application

After the Directive Implementation Date, the following requirements must be complied with by all EU Managers and Non-EU Managers that are marketing Funds to EU investors, regardless of whether the Manager is using a passport or relying on the Private Placement Exemption.

#### 1. Marketing to Retail Investors

Under the Directive, individual Member States may adopt rules to permit Managers to market Funds that they manage to investors other than professional investors (*i.e.*, retail investors)<sup>9</sup> in their respective jurisdictions (Art. 41(1)). In such cases, Member States may subject such Managers and Funds to stricter requirements than are imposed under the Directive, although they may not impose stricter or additional requirements on EU Funds that are established in other Member States and marketed on a cross-border basis than on Funds marketed domestically (Art. 41(1)). Within one year after the Directive Implementation Date, any Member State that will permit marketing to retail investors must inform the Commission and the ESMA of the types of Funds that may be marketed to retail investors in their Member State and any additional requirements that will apply in respect of such marketing (Art. 41(2)).

Thus, the Directive grants Member States wide latitude in developing rules applicable to Managers relying on Private Placement Exemptions in their Member State. Therefore, absent other indications, it is not expected that Member States’ current Private Placement Exemptions will be significantly changed following the Directive Implementation Date. It is unclear, however, whether Managers will be permitted to market Funds to investors other than professional investors after the Private Placement Exemptions are abolished (if indeed they are).

#### 2. Disclosure and Reporting<sup>10</sup>

Managers will be required to disclose certain information to investors, both prior to investing and periodically thereafter, as well as submit an annual report to the appropriate national regulator (Art. 22(1)).

Among other information, investors will be entitled to receive:

- a description of the investment strategy and objectives of the Fund, including details of the circumstances under which the Fund may use leverage and the associated risks;
- details of the Fund’s depositary (*i.e.*, custodian), auditor and other service providers;
- a description of the Fund’s liquidity risk management; and
- a description of all fees, charges and expenses and the maximum amounts thereof that are directly or indirectly borne by investors (Art. 23(1)).

With respect to each EU Fund that the Manager manages and each Fund that the Manager markets in the EU, the Manager must make available an annual report to the relevant Member State regulator copies of the report to investors on request (Art. 22(1)). The report will have to contain, at a minimum:

- a balance-sheet/statement of assets and liabilities;
- an income and expenditure account;
- a report on the activities of the previous financial year;
- any material changes to the information previously disclosed to investors; and
- the total amount of remuneration to staff members and the aggregate amount of remuneration broken down by senior management and members of staff (Art. 22(2)).

The accounting information provided in the annual report must be audited and prepared in accordance with the accounting standards of the Fund’s home Member State or third country, as applicable (Art. 22(3)). In addition, Managers will be required to report “regularly” to the appropriate Member State regulator, on matters including:

- the percentage of the Fund’s assets that are subject to “special arrangements” arising from their illiquid nature (at this stage no further information is given in the Directive regarding such special arrangements: it may include side

- pockets and/or restrictions on redemption, although it remains to be seen how the Commission develops this concept);
- any new arrangements for managing the liquidity of the Fund; and
  - the current risk profile of the Fund and the risk management systems used (Art. 24(1), (2)).

### 3. *Controlling Interests*

The Directive introduces new rules governing controlling interests applicable to Managers of Funds that take significant stakes (over 50%) in non-listed companies (Art. 26 through Art. 30). As a matter of practice, these rules typically will not apply to funds commonly referred to as hedge funds. The rules require the Manager to provide notices and disclosures that will advise the target company, its shareholders and employees, and the relevant Member State regulators of the Manager's identity, its intentions with regard to the target company's future business, and other information (Art. 27, 28). In addition, the Directive prohibits "asset stripping" for a period of two years after the Fund acquires control of the target company (Art. 30).

## D. *Passporting Requirements*

The following provisions must be satisfied by a Manager that is marketing Funds to EU investors pursuant to a passport. A Non-EU Manager relying on the Private Placement Exemptions will not be required to comply with these requirements.

### 1. *Capital Adequacy*

The Directive requires a Manager that is appointed as an external manager of a Fund to hold an initial capital base of at least €125,000 plus additional capital of 0.02 percent of the amount by which Manager-managed assets exceed €250 million, subject to a total cap of €10 million (Art. 9(2), (3)). In any event, the Manager must maintain capital equivalent to one quarter of one year's operating expenses (less certain variable costs), as is now required under the EU Capital Adequacy Directive for EU Managers within the scope of MiFID (Art. 9(5)). For small Managers subject to the Directive, the initial capital required under the Directive is likely to be significantly higher than that currently required under MiFID.

The Directive also requires a Manager to cover potential professional liability risks resulting from its activities by either: (i) maintaining additional funds that are appropriate to cover potential liability risks arising from professional negligence; or (ii) holding an appropriate professional indemnity insurance against liability arising from professional negligence which is appropriate to the risks covered (Art. 9(7)).

### 2. *Operating Conditions*

The Directive lays down certain general principles for conduct of business requirements for Managers. These include requirements that the Manager:

- act honestly, with due skill, care and diligence and fairly (Art. 12(1)(a));
- act in the best interests of the Fund it manages, the investors in the Fund and the integrity of the market (Art. 12(1)(b));
- ensure that all Fund investors are treated fairly (Art. 12(1)(f));
- implement and maintain effective organizational and administrative arrangements to prevent conflicts of interest arising (Art. 14(1));
- functionally and hierarchically separate the functions of risk management and portfolio management, and implement and regularly review risk management systems, including implementing an appropriate, documented and regularly updated due diligence process when investing on behalf of the Fund (Art. 15(1) - (3)); and
- employ appropriate liquidity management systems and regularly conduct "stress tests" (Art. 16(1)).

The Directive requires the Commission to adopt, at a later date, implementing measures laying down requirements in relation to investment in securitization positions (Art. 17(1)).

### 3. *Remuneration*

The Directive requires Managers to have remuneration policies and practices for members of staff whose activities have a material impact on the risk profiles of the Funds they manage (including

senior management, risk takers, control functions and any employee receiving remuneration that is equivalent to that of senior management and risk takers). Such policies must be consistent with and promote sound and effective risk management and not encourage risk taking inconsistent with the risk profiles and rules of the Funds they manage (Art. 13(1)).

Annex II of the Directive sets out the principles that a Manager must follow in determining its remuneration policy in a way and to the extent that is appropriate to the Manager's size, internal organization and the complexity of its activities. The extensive list of principles includes:

- the policy's promotion of sound and effective risk management;
- independent and central review of the remuneration policies at least annually;
- performance-related remuneration takes into account financial and non-financial criteria;
- assessment of performance is set in a multi-year framework appropriate to the life cycle of the Fund managed;
- guaranteed variable remuneration being exceptional and only occurring in the context of hiring new staff and limited to the first year;
- payments related to early termination of a contract reflect performance achieved over time and do not reward failure;
- at least 50% of variable remuneration consists of interests in the Fund (or equivalent ownership interests);
- a substantial portion (at least 40% of any variable remuneration) being deferred over a period that is appropriate to the life cycle of the Fund, such period to be at least three to five years (unless the Fund life cycle is much shorter); and
- deferred amounts being subject to negative adjustment in the event of poor financial performance of the Fund or Manager, including through claw back arrangements.

These principles are very similar to those established by the CRD III rules on remuneration and for further

information please see our previous client alert by clicking [here](#).<sup>11</sup> The principles apply to all remuneration, including carried interests and transfers of shares or units of the Fund.

Managers that are significant in terms of size or the size of the Funds they manage are required to establish a remuneration committee, which must consist of and be chaired by non-executive members of the management body of the Manager (Annex II, par. 3).

#### 4. *Leverage*

Under the Directive, a Manager employing leverage on a systematic basis above a defined threshold will be required to disclose aggregate leverage and the main sources of leverage to its home Member State regulator (Art. 24(4)).<sup>12</sup> As noted above, the Directive defines "leverage" as any method by which a Manager increases the exposure of a Fund that it manages, whether through the borrowing of cash or securities, or leverage embedded in derivative positions, or by any other means (Art. 4(1)(w)). A Manager must demonstrate that the leverage limits for each Fund it manages are reasonable and these limits are complied with at all times (Art. 25(3)). Home Member State regulators are to assess the risks that uses of leverage have and, when deemed necessary in order to ensure the stability and integrity of the financial system, must impose limits to the level of leverage a Manager may employ (Art. 25(3)).

#### 5. *Independent Valuation Agent*

The Directive also introduces new rules obliging Managers to ensure that, for each Fund that they manage, appropriate and consistent procedures are established so that a proper and independent valuation of the assets of the Fund can be performed at least once a year (Art. 19(1), (3)).

The Manager must ensure that the valuation function is performed by either: (i) an external independent valuer; or (ii) the Manager itself, provided that the valuation task is functionally independent from the portfolio management and remuneration policy and other measures are in place to ensure conflicts of interest are mitigated and any undue influence on employees is prevented (Art. 19(4)).

The rules relating to the valuation of a Fund's assets and calculation of the net asset value per share or

unit of the Fund are to be set forth in the law of the country where the Fund has its registered office and/or in the Fund's rules or instruments of incorporation (Art. 19(2)). Importantly, if an external independent valuer is used, it must be appointed by the Manager as its delegate, rather than by the Fund as would be normal at present (Art. 19(5)(c)).

### **E. Depositary Requirements**

The following provisions generally are applicable, but are not required to be complied with by: (i) Managers marketing Non-EU Funds pursuant to a Private Placement Exemption; (ii) EU Managers managing (but not marketing in the EU) Non-EU Funds; and (iii) Non-EU Managers marketing EU Funds that they do not manage, pursuant to a Private Placement Exemption.

The Directive will require a Manager to appoint a single depositary for each Fund that it manages (Art. 21). The depositary will act as custodian for the Fund's assets and will be responsible for, among other things, monitoring the Fund's cash flows, ensuring that transactions involving Fund shares or units comply with national law and ensuring that the value of Fund shares or units is calculated in accordance with applicable national law and Fund rules (Art. 21(6), (7), (8)). A depositary will be subject to near strict liability for the loss of custody assets and, although the depositary may delegate its custodian tasks to other depositaries, it remains contractually liable to the Fund (or to the Manager, acting on behalf of the Fund) for the delegate's loss of custody assets (Art. 21(10), (11),(12)), subject to a limited exception in a case where the Fund has a direct claim against the delegate in respect of loss of financial instruments.

The depositary may be: (i) an EU credit institution; (ii) an EU investment firm; or (iii) any other institution that is subject to prudential regulation and ongoing supervision and is eligible to be a depositary for the cash and other assets of a UCITS (Art. 21(3)). The depositary may not be: (i) the Manager; (ii) the Fund's external valuation agent, unless the valuation functions are functionally and hierarchically separated from the depositary functions; or (iii) a prime broker acting as a counterparty to the Fund, unless the prime broker tasks are functionally and hierarchically separated from the depositary functions and potential conflicts of interest are addressed (Art. 19(4), 21(4)).

With respect to Funds domiciled in Non-EU countries, the Directive provides that the depositary of a Non-EU Fund may be established in: (i) the Fund's home country;<sup>13</sup> (ii) the Manager's home Member State; or (iii) the Member State of reference of the Manager (Art. 21(5)(b)). Thus, a Non-EU Manager may not use a depositary established in its home country, unless the Fund is established in the same country.

A U.S.-registered investment adviser with custody of client assets that manages EU Funds or that wishes to market Funds into the EU using a passport may be subject to both the depositary rules in the Directive and the custody rule under the U.S. Investment Advisers Act of 1940 (the "Advisers Act"). The Directive will require that an EU credit institution be appointed as depositary of the Fund. This, however, may not be compliant with the Advisers Act custody rule, which allows U.S.-registered investment advisers with custody of client assets to place those assets in the custody of an EU financial institution only under specific conditions.<sup>14</sup> In addition, U.S. mutual funds that are marketed to EU investors (regardless of whether such funds are sub-advised by an EU-domiciled sub-adviser) are subject to other specific requirements with respect to the financial institutions that maintain custody of their assets.

Furthermore, if the Fund managed by the U.S.-registered investment adviser does appoint an EU credit institution as depositary, that depositary will only be able to delegate custody back to a U.S.-based depositary if the relevant Fund is U.S.-domiciled and the EU considers the level of protection provided by the Advisers Act custody rule is equivalent to that in the EU (and it is unknown what the determination might be on this).

### **IV. What is the Proposed Time Frame and Process?**

As noted above, the Parliament approved the Directive on November 11, 2010. The next stage is for the Directive to be adopted by the Council of the EU and translated into the languages of the EU Member States, which is expected to occur over the next few weeks, possibly by early 2011. The Directive then will be published in the Official Journal of the European Union and will become legally binding on Member States twenty days thereafter (Art. 65). Member States then must

implement the Directive into national legislation within two years from the Directive Implementation Date (which is anticipated to be early 2013) (Art. 63(1)).

The legislative process does not end here. The Directive authorizes ESMA to issue guidance and recommendations on significant issues under the Directive, including whether the passport regime should be introduced with respect to Non-EU Funds and whether the Private Placement Exemptions should be terminated (Art. 63bis(1), Art. 63ter(1)). In addition, the Directive delegates to the

Commission rule-making authority with respect to the interpretation and implementation of various provisions of the Directive, including determining when the Private Placement Exemptions will be terminated (if so recommended by ESMA) (Art. 63ter(6)). This Level 2 implementing legislation is where much of the important detail of the Directive will be decided and will warrant close attention as it is proposed and adopted by the Commission.

Anchorage Austin Beijing Berlin Boston Charlotte Chicago Dallas Dubai Fort Worth Frankfurt Harrisburg Hong Kong London Los Angeles Miami Moscow Newark New York Orange County Palo Alto Paris Pittsburgh Portland Raleigh Research Triangle Park San Diego San Francisco Seattle Shanghai Singapore Spokane/Coeur d'Alene Taipei Tokyo Warsaw Washington, D.C.

K&L Gates includes lawyers practicing out of 36 offices located in North America, Europe, Asia and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information, visit [www.klgates.com](http://www.klgates.com).

K&L Gates comprises multiple affiliated entities: a limited liability partnership with the full name K&L Gates LLP qualified in Delaware and maintaining offices throughout the United States, in Berlin and Frankfurt, Germany, in Beijing (K&L Gates LLP Beijing Representative Office), in Dubai, U.A.E., in Shanghai (K&L Gates LLP Shanghai Representative Office), in Tokyo, and in Singapore; a limited liability partnership (also named K&L Gates LLP) incorporated in England and maintaining offices in London and Paris; a Taiwan general partnership (K&L Gates) maintaining an office in Taipei; a Hong Kong general partnership (K&L Gates, Solicitors) maintaining an office in Hong Kong; a Polish limited partnership (K&L Gates Jamka sp.k.) maintaining an office in Warsaw; and a Delaware limited liability company (K&L Gates Holdings, LLC) maintaining an office in Moscow. K&L Gates maintains appropriate registrations in the jurisdictions in which its offices are located. A list of the partners or members in each entity is available for inspection at any K&L Gates office.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2010 K&L Gates LLP. All Rights Reserved.

<sup>1</sup> The Directive defines a "Manager" as any entity whose regular business is providing portfolio management services **or** risk management services to one or more "Funds," as defined.

<sup>2</sup> The European Commission of the EU has previously stated that, while the activities of Managers are regulated by a combination of national financial and company law regulations and general provisions of European Community law supplemented by industry-developed standards, recent events have indicated that some of the risks associated with Managers have been underestimated and are not sufficiently addressed by current rules. The Commission believes that the current EU regulatory environment does not adequately reflect the cross-border nature of the risks.

The Commission is of the view that effective management of the cross-border dimension of these risks demands:

- a common understanding of the obligations of Managers;

- a coordinated approach to the oversight of risk management processes, internal governance and transparency; and
- clear arrangements to support supervisors in managing these risks, both at the domestic level and through effective supervisory cooperation and information sharing at the European level.

<sup>3</sup> A "professional investor" includes: (i) entities required to be authorized or regulated to operate in the financial markets; and (ii) large undertakings meeting two of the following three requirements:

- (i) Balance sheet total of at least €20m;
- (ii) Net turnover of at least €40m; and
- (iii) Own funds (essentially permanent capital) of at least €2m.

A "professional investor" also includes other institutional investors whose main activity is to invest in financial instruments. Individuals and others who meet at least two of the following criteria may be included in the "professional investor" definition where they are able to give adequate

assurances that they are capable of making their own investment decisions and understand the risks involved:

- (i) The client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters;
- (ii) The size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds €500,000; and
- (iii) The client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

<sup>4</sup> The legislature of the EU is comprised of the Parliament (consisting of elected representatives from across the Member States) and the Council (representing the governments of the Member States and composed of national ministers from each State). The Directive must be approved by both the Parliament and the Council to come into force. The Commission does not have a legislative role but instead is the executive body of the EU, being the institution which is responsible for proposing legislation, implementing decisions, upholding EU treaties and the general day-to-day running of the EU.

<sup>5</sup> ESMA has been granted wide-ranging powers in connection with the implementation of the Directive. In particular, ESMA may define and regularly review guidelines for competent authorities on the exercise of their authorization powers and reporting obligations under the Directive (Art. 45(1)). In addition, ESMA may, inter alia, where there is a threat to financial stability, request a competent authority or authorities to: (i) prohibit the marketing using Private Placement Exemptions of shares or units in the EU of a Fund managed by a Non-EU Manager or of a Non-EU Fund managed by an EU Manager; (ii) impose restrictions on Non-EU Managers relating to the management of Funds in case of excessive concentration of risk in a specific market on a cross-border basis; and (iii) impose restrictions on Non-EU Managers where the Funds' activities potentially constitute an important source of counterparty risk to a credit institution or other systemically relevant institution (Art. 45(4)). Such decisions may however only be made if: (i) a substantial threat exists to the orderly functioning and integrity of the financial market or to the stability of the financial system in the EU and there are cross-border implications; and (ii) the relevant competent authority has not taken measures to address the threat (Art. 45(5)).

<sup>6</sup> The thresholds will be calculated based on the assets of Funds managed by the Manager either directly or indirectly through a company with which the Manager is linked by common management or control, or by a substantive direct or indirect holding (Art. 3(2)(a)).

<sup>7</sup> Under Article 33 of the Directive, "an authorised EU [Manager] may manage EU [Funds] established in another Member State either directly or via the establishment of a branch, provided that the [Manager] is authorised to manage that type of [Fund]."

<sup>8</sup> It is possible that the legal representative will constitute a "permanent establishment," of either the Non-EU Manager

or of the Fund, for tax purposes with the result that a proportion of the profits of the non-EU Manager or the Fund would be taxable in the jurisdiction of the legal representative. In practice, however, an exemption from "permanent establishment" status should be available under the relevant tax legislation governing the legal representative.

<sup>9</sup> For purposes of the Directive, a "retail investor" is any investor who is not a professional investor (Art. 4(1)(ak)).

<sup>10</sup> However, an EU Manager need not prepare an annual report for a Non-EU Fund it manages but does not market in the EU (Art. 23(1)).

<sup>11</sup> See our client alerts on the FSA's Remuneration Code [here](#).

<sup>12</sup> For Non-EU Managers, this requirement applies only to EU Funds that they manage and Non-EU Funds that they market in the EU (Art. 24(4)).

<sup>13</sup> The country where the depositary is established must (i) meet the Cooperation Condition, the AML Condition and the Tax Treaty Condition; and (ii) have legislation that provides for effective prudential regulation (including minimum capital requirements) and supervision as laid down in EU law (Art. 21(5)(b)).

<sup>14</sup> See Rule 206(4)-2 under the Advisers Act.