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Authors:**Philip J. Morgan**philip.morgan@klgates.com
+44.(0)20.7360.8123**Anna Paglia**anna.paglia@klgates.com
+1.312.781.7163**Neil Nick Robson**neil.robson@klgates.com
+44.(0)20.7360.8130**Cary J. Meer**cary.meer@klgates.com
+1.202.778.9107**Mark D. Perlow**mark.perlow@klgates.com
+1.415.249.1070

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European Commission Proposes Regulation of Alternative Investment Fund Managers

On 29 April 2009, the European Commission (the "Commission") of the European Union ("EU") published its much-anticipated "Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers" (the "Proposal" and the "Directive"). The Commission has indicated its desire to spearhead the world regulatory response to the current financial crisis, with the Proposal forming part of an ambitious Commission programme to extend appropriate regulation and oversight to all activities that the Commission considers present and/or create significant risks.

The Proposal, which is planned for implementation in 2011, would regulate managers of alternative investment funds ("AIFMs") where those managers are either domiciled in the EU or are offering alternative investments funds ("AIFs") to European investors. Under the Proposal, AIFs would include all collective investment undertakings that are not compliant with the Undertakings for Collective Investments in Transferable Securities Directive ("UCITS") (hedge funds, private equity funds, real estate funds, infrastructure funds as well as mutual funds domiciled and registered in the United States). Non-EU investment firms managing AIFs offered to European investors would fall within the scope of the Directive, as would EU investment firms that serve as sub-advisers to mutual funds domiciled in the United States provided those firms also manage EU-domiciled AIFs and/or market AIFs in the EU. As we describe below, if the final form of the Directive matches the Proposal, it is likely that U.S. fund managers wishing to continue to market their AIFs in the EU will be forced to establish a place of business in the EU and become authorized under the Directive.

Who Will be Affected?

If the final form of the Directive matches the Proposal, not all AIFMs will fall within its scope. Only AIFMs that wish to manage and/or market AIFs in the EU will need to be authorised under the Directive. Furthermore, the Directive will apply only to those AIFMs that (either directly or indirectly through a company with which the AIFM is linked by common management or control, or by a substantive direct or indirect holding) manage portfolios of AIFs whose assets under management in total exceed €100 million, irrespective of the number of AIFs that they manage. The €100 million threshold includes any assets acquired by AIFs through the use of leverage. Any AIFMs below this threshold are deemed by the Commission to be unlikely to have significant consequences for financial stability or market efficiency. For AIFMs managing AIFs that do not use leverage (and that also have a five-year lock-in period for investors), such as the typical venture capital fund, the threshold will be raised to €500 million, since the Commission does not believe that these AIFMs pose the same systemic risks. The Proposal would exempt AIFMs that do not exceed the threshold(s), and these AIFMs would not have any rights under it, although they would be able to opt to apply for authorisation under the Directive, for example to secure passporting benefits.

The Proposal does not make it clear whether AIFMs that manage both (1) AIFs that do not use leverage and that have a five-year lock-in and (2) AIFs that do use leverage will be required to aggregate the assets under management in those AIFs together for the purposes of assessing whether an AIFM exceeds the €100 million or €500 million thresholds. We will have to wait for a revised draft of the Proposal to see whether or how the Commission addresses this concept.

Will it Affect me?

1. My Firm is domiciled in an EU Member State and it is authorised/licensed under the Markets in Financial Instruments Directive ("MiFID").

1.1 We manage EU AIFs and are subject to the Directive. Will we have to apply for separate authorisation under the Directive?

In the introductory notes to the Proposal, the Commission specified that investment firms authorised under MiFID should not be required to obtain a separate authorisation under the Directive in order to provide investment services in respect of AIFs. However, it is currently unclear in the Proposal whether your Firm would be able to market AIFs in other Member States using the Directive's passporting rights in the absence of specific authorisation under the Directive.

1.2 How does this differ if we manage non-EU AIFs and wish to market them in the EU?

You would, after a date expected to be in 2014 (if the Proposal is implemented as currently envisaged), need to obtain (i) an authorization to market the AIFs in the Member State where your Firm is domiciled and (ii) a passport to market the AIFs into other EU Member States. This would only be available if the non-EU country in which your AIF is domiciled has entered into an agreement based on Article 26 of the OECD Model Tax Convention with the EU Member State in whose territory the AIF is proposed to be marketed and has agreed an effective exchange of information in tax matters with the relevant EU Member State (each an "OECD Article 26 Compliant Jurisdiction"); it remains to be seen which jurisdictions will be compliant. Although the OECD confirmed (as at

19 May 2009) that the United States has "substantially implemented" Article 26 of the OECD Model Tax Convention, it cannot be defined as an OECD Article 26 Compliant Jurisdiction as it has not entered into tax information sharing agreements with any EU Member States.

Before 2014, you will, as currently, be permitted to market non-EU AIFs around the EU subject to domestic marketing and private placement rules in each Member State.

1.3 How does this differ if we only manage non-EU domiciled AIFs and do not market them in the EU?

Your Firm would continue to be required to be authorised under national legislation implemented pursuant to MiFID; however, the Proposal explicitly states that the Directive will not apply to AIFMs established in the EU that do not provide management services to AIFs domiciled in the EU and that do not market AIFs in the EU. Therefore, if the Proposal is implemented as envisaged the Directive would not apply to your Firm.

2. My Firm is based outside the EU and provides management services to AIFs established in the EU. Am I required to apply for authorisation under the Directive?

Although it is not completely clear from the Proposal, it appears that you would need to become an authorised AIFM under the Directive to perform these services.

3. My Firm is based outside the EU and provides management services to AIFs established outside the EU.

3.1 I wish to market these AIFs in the EU. How does the Directive affect me?

The answer is the same as the answer to question 1.2 above, except that the AIFM need not necessarily have an office in the EU to become appropriately authorised under the Directive. This would, however, be subject to certain onerous requirements regarding the non-EU AIFM's home country, namely that: (1) that country is an OECD Article 26 Compliant Jurisdiction, (2) that country is deemed by the

Commission to have legislation for prudential regulation and on-going supervision equivalent to the Directive, (3) that country has effective market access comparable to that granted by the EU to AIFMs from that non-EU country, and (4) the non-EU AIF providing the competent authorities of the Member State in which it applies for authorisation with the necessary information.

3.2 What if my Firm is based in the United States?

The United States is not currently an OECD Article 26 Compliant Jurisdiction; U.S. legislation regarding prudential regulation and on-going supervision is unlikely to be deemed by the Commission to be equivalent to the Directive (for example, U.S. hedge fund managers are not currently required to maintain regulatory capital nor are these managers currently required to be registered with the Securities and Exchange Commission, the U.S. securities regulator); and market access between the EU and the United States is not on a level footing (regulators in the EU and the United States have failed to agree reciprocal access for UCITS funds and U.S. mutual funds for over 30 years).

In our view, it would be extremely difficult for the authorisation conditions referred to above to be satisfied by most jurisdictions, and it is therefore likely that non-EU fund managers wishing to continue to market their AIFs in the EU will be forced to establish a place of business in the EU and become authorised under the Directive.

4. My Firm is established outside the EU and does not actively market AIFs to European professional investors but we nonetheless receive calls and subscription requests from European clients? Does my Firm fall under the provisions of the Directive?

The Proposal defines marketing as any general offering or placement of units or shares in an AIF to or with investors domiciled in the EU regardless of at whose initiative the offer or placement takes place. If EU-domiciled investors are able to access such an offer, then both your Firm and the AIF would potentially

fall under the Directive. In such circumstances, it might be necessary to put measures in place to ensure that the materials and your website are inaccessible to investors in the EU, although, until the Directive and its implementing measures are developed and finalised, we are unable to comment with certainty.

More detail on the questions assessed above is considered in the remainder of this document.

How Can an AIFM Become Authorised Under the Directive?

To become authorised, the AIFM would have to show that it is suitably qualified to provide AIF management services. It would have to provide detailed information on its planned activities, the identity and characteristics of the AIF to be managed and its internal arrangements for governance, risk management, valuation and safe-keeping of assets, audit and regulatory reporting arrangements.

Aren't AIFMs Already Regulated at the National Level?

The Commission stated its view that, while the activities of AIFMs are regulated by a combination of national financial and company law regulations and general provisions of Community law supplemented by industry-developed standards, recent events have indicated that some of the risks associated with AIFMs 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 AIFMs;
- 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.

What are the Main Elements of the Proposal?

Marketing of AIFs

Under the Proposal, AIFMs authorised in their home State would be entitled to market their AIFs to professional investors in the EU. Individual Member States may permit the promotion of AIFs to retail investors in their Member State, subject to stricter requirements that are yet to be defined. The marketing of AIFs across EU borders would be subject to a notification procedure under which certain information would be provided to the regulator in the home State and passed on to the host State regulator. EU-regulated AIFMs would also be able to passport their management services into other Member States, subject to a notification procedure, although this would appear to overlap with similar passporting rights under MiFID for AIFMs that are currently within the scope of MiFID.

Non-EU Funds

Under passporting provisions in the Proposal, EU-regulated AIFMs may market non-EU domiciled AIFs in the EU, provided that the AIF's country of domicile is an OECD Article 26 Compliant Jurisdiction.

The section of the Proposal relating to the marketing of non-EU AIFs will not become effective until the end of a three-year transitional period. If the Directive is adopted by the end of this year in accordance with current plans, EU Member States are expected to have until the end of 2011 to implement it into national legislation, so that these provisions are unlikely to be in force until 2014 at the earliest. In the meantime, non-EU domiciled AIFs may be marketed in the EU, subject to currently applicable domestic private placement and marketing rules.

It would appear that, under the current Proposal, any AIFM wishing to market AIFs in the EU would need to become an EU-regulated AIFM.

Regulation of AIFMs Based Outside the EU

The Proposal envisages that regulators in Member States will be able to authorise AIFMs established outside the EU to market AIFs to professional investors within the EU, subject to specific

conditions. The proposed conditions for such authorisation do not require that the non-EU AIFM, such as a typical U.S.-based investment adviser, have an office in the EU but do require that:

- the non-EU AIFM's home country is deemed by the Commission to:
 - have legislation regarding prudential regulation and on-going supervision that is equivalent to the Directive and that those rules are adequately enforced; and
 - grant EU-regulated AIFMs effective market access comparable to that granted by the EU to AIFMs from that non-EU country;
- the non-EU AIFM provides the competent authorities of the Member State in which it applies for authorisation with the information that an EU-domiciled AIFM would be required to provide to the EU regulator;
- there is a cooperation agreement between the competent authorities of the relevant Member State and the home supervisor of the AIFM which ensures an efficient exchange of all relevant information; and
- the third country is an OECD Article 26 Compliant Jurisdiction.

Some additional questions that the Proposal leaves unanswered include the following:

- Place of Business: it is not clear whether, in case the U.S. fund manager is required to establish a place of business in a Member State, this has to be established in the form of a representative office, a subsidiary or a branch. Depending on the outcome, there may be tax and regulatory implications for the U.S. fund manager.
- Domicile of Choice: assuming that the U.S. fund manager intends to offer AIFs to investors residing in different Member States, it is unclear whether the U.S. fund manager will be obliged to register in a prescribed Member State or whether it will be allowed to have its own domicile of choice (and decide, for example, to establish its place of business in the UK even if

the AIF counts only one investor in the UK and 50 investors in France).

- **Existing Clients:** assuming that investors residing in different Member States participate in non-EU AIFs managed by a U.S. fund manager, and assuming that the U.S. fund manager does not plan on marketing the AIFs after the 2014 deadline, it is unclear whether (1) the U.S. fund manager will nonetheless fall within the scope of the Directive and be required to register in a Member State, (2) the U.S. fund manager will be obliged to redeem the interests of European investors from the AIF in the absence of registration, or (3) the U.S. fund manager will be authorised to keep its existing investors while the prohibition on marketing the AIF will apply to new investors only.

We will have to wait for a revised draft of the Proposal to see how the Commission develops these proposals and whether the authorisation conditions are relaxed.

Capital Adequacy

The Proposal envisages that AIFMs would be required to hold a minimum capital base of €125,000, plus additional capital of 0.02 per cent of the amount by which AIFM-managed assets exceed €250 million. In any event, AIFMs would have to maintain capital equivalent to one quarter of one year's operating expenses (less certain variable costs), as is already required by the EU Capital Adequacy Directive.

The minimum capital requirement under MiFID is currently €50,000, so it may be that some managers who are subject to the Directive would have increased regulatory capital requirements.

Operating Conditions

The Proposal lays down certain general principles for conduct of business requirements for AIFMs. These include requirements on the AIFM to:

- act honestly, with due skill, care and diligence and fairly;
- act in the best interests of the AIF it manages, the investors in the AIF and the integrity of the market;

- ensure that all AIF investors are treated fairly;
- implement and maintain effective organisational and administrative arrangements to prevent conflicts of interest arising;
- separate the functions of risk management and portfolio management, and implement and regularly review risk management systems, including an appropriate, documented and regularly updated due diligence process when investing on behalf of the AIF; and
- employ appropriate liquidity management systems and regularly conduct "stress tests."

The Commission has also indicated that it will, at a later date, adopt implementing measures laying down requirements in relation to investment in securitisation positions.

Disclosure and Reporting

AIFMs would be required to disclose certain information to investors, both prior to investing and periodically thereafter, as well as submitting an annual report to the appropriate national regulator.

Among other information, investors would be entitled to receive:

- a description of the general investment strategy and objectives of the AIF, including details of potential use of leverage and the associated risks;
- details of the AIF's depository (*i.e.*, custodian), "valuator," auditor and other service providers;
- a description of the AIF's liquidity risk management; and
- a description of all fees, charges and expenses.

The annual report submitted by AIFMs to the relevant national regulator, copies of which would then have to be made available to investors, would have to contain for each of the AIFs that the AIFM manages at least:

- a balance-sheet/statement of assets and liabilities;
- an income and expenditure account; and

- a report on the activities of the previous financial year.

In addition, AIFMs would be required to report "regularly" to the appropriate national regulator, on matters including:

- the percentage of the AIF's assets that are subject to "special arrangements" arising from their illiquid nature (at this stage no further information is given in the Proposal regarding such special arrangements - it may include side pockets and/or restrictions on redemption, although we will have to wait for a revised draft of the Proposal to see how the Commission develops this concept);
- any new arrangements for managing the liquidity of the fund; and
- the current risk profile of the AIF and the risk management systems used.

Leverage

Under the Proposal, an AIFM employing leverage on a systematic basis above a defined threshold would be required to disclose aggregate leverage and the main sources of leverage to its home State regulator. The Proposal defines "leverage" as any method by which an AIFM increases the exposure of an AIF that it manages to a particular investment, whether through the borrowing of cash or securities, or leverage embedded in derivative positions such as futures and swaps, or any other means. The Commission has also stated that it intends to adopt implementing measures to restrict leverage by AIFMs, and we assume that the focus here will be on systemically significant AIFMs and AIFs, although to be sure we will have to wait for a revised draft of the Proposal to see how the Commission develops this concept. It would also grant emergency powers to national regulators to restrict use of leverage by AIFMs and AIFs in exceptional circumstances.

Controlling Interests

The Proposal would also introduce new rules governing controlling interests, where AIFs managed by AIFMs take significant stakes (over 30%) in non-listed companies, although these rules would only apply to those companies that have more than 250 employees, an annual turnover in excess of

€50 million and/or an annual balance sheet that exceeds €43 million. The AIFM would be required to provide a notification and disclosures to the target company and its shareholders, as well as the target company's employee representatives, not later than four trading days after the AIFM becomes able to exercise 30% of the voting rights. The notification must contain:

- the resulting situation in terms of voting rights;
- the conditions under which the 30% threshold has been reached, including information about the identity of the different shareholders involved; and
- the date on which the 30% threshold was reached or exceeded.

The disclosures include:

- the identity of the AIFM (which either individually or in agreement with other AIFMs) that has reached the 30% threshold;
- a development plan for the non-listed company;
- the policy for preventing and managing conflicts of interests, in particular between the AIFM and the non-listed company; and
- the policy for external and internal communication of the issuer or non-listed company, in particular as regards employees.

Independent Valuation Agent

The Proposal would also introduce new rules obliging AIFMs to ensure that each AIF that it manages appoints an independent valuation agent. Where the registered office of a valuation agent is in a non-EU country, the Proposal would require that the Commission must first have assessed the valuation rules and standards used by valuation agents in the relevant country as being equivalent to those applicable in the EU.

Under the Proposal, where a UK AIFM has been appointed as a sub-adviser by an affiliated U.S. fund manager, the UK AIFM will not be able to comply with the requirements unless each AIF that the AIFM advises has appointed an independent valuation agent. In the United States, for example, certain types of funds do not typically have an independent valuation agent, so it currently appears

that UK affiliates of a U.S. manager of those funds might have to discontinue their sub-advisory activities with respect to those funds.

Depositaries

The Proposal would also introduce new rules obliging AIFMs to ensure that each AIF that it manages appoints an EU credit institution as a depositary (*i.e.*, custodian) of its cash and other assets. The Proposal provides that the depositary may delegate its tasks to other depositaries. Although the Proposal provides little detail, it does suggest that depositaries to which these tasks are delegated could be established in non-EU countries provided that "the necessary safeguards are in place." The Proposal does not suggest what such safeguards might be.

With respect to AIFs domiciled in non-EU countries, the Proposal suggests that the EU depositary may delegate its depositary tasks to a depositary domiciled in the same non-EU country as the relevant AIF, provided that the legislation of the relevant country provides a level of protection of investor interests that is equivalent to that in the EU.

A U.S.-registered investment adviser with custody of client assets that manages AIFs that it wishes to market into the EU 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 "IAA") (although the IAA custody rule will not affect unregistered U.S. fund managers that manage hedge funds and private equity funds). The Directive would require that an EU credit institution be appointed as depositary of the AIF; however, this may not be compliant with the IAA custody rule. Rule 206(4)-2 under the IAA 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, particularly that the EU financial institution segregates customer assets from proprietary assets. Moreover, the U.S. Investment Company Act of 1940 permits U.S.-registered investment companies (whether or not sub-advised by an EU-based sub-adviser) to maintain their assets in financial institutions only if they are U.S.-chartered.

Furthermore, if the AIF managed by the U.S.-registered investment adviser does appoint an EU

credit institution as depositary, that depositary would only be able to delegate custody back to a U.S.-based depositary if either (1) the relevant AIF is U.S.-domiciled and the EU considers the level of protection provided by the IAA custody rule is equivalent to that in the EU (and it is unknown what the determination might be on this), or (2) "the necessary safeguards are in place," which is clearly a concept that needs to be developed before it can be understood properly.

If the Directive's provisions on depositaries are not modified before the final draft of the Directive is required to be implemented in Member States, perhaps the result would be that (1) U.S.-registered investment advisers that manage unregistered funds might have to close down their EU operations to avoid falling within the scope of the Directive and (2) EU managers that sub-advise U.S.-registered investment companies might also find themselves compelled to give up those mandates.

What has the Reaction Been so Far?

The Proposal has generally been received very negatively by those professionals who would have to comply with the new rules. In the UK, much consternation has focused on the fear that the burden of extra regulation will drive fund managers away from the UK (where around 80 percent of European AIFMs are located), particularly if rival non-EU jurisdictions, such as the United States and Switzerland, adopt a lighter touch. There is a widespread feeling in the UK that the Proposal is largely driven by countries such as France and Germany that have not traditionally supported the development of a domestic market for AIFs.

What is the Proposed Time Frame and Process?

The process leading to implementation in Member States is expected to take around 18 months, which, although a significant period of time, is much quicker than many other EU financial services directives. The Directive must first pass through the Council of the European Union and the European Parliament (which is currently in the midst of an election cycle), who may make significant amendments before adopting it. Some difficulty is likely to arise in the Parliament in particular, where the European People's Party, which considers the

Proposal to be “headed in the right direction,” disagrees with the European Socialist Party, which issued a statement saying the Proposal was like “Swiss cheese” and full of loopholes. Any adopted Directive will then be subject to what is known as the “Lamfalussy” process, whereby further implementing measures will be used to elaborate on the broader principles contained in the Directive.

There is currently no procedure for industry participants to provide comments, since the Proposal is still in discussion within the Council of the European Union and the European Parliament. However, there is usually scope for consultation and for parties to provide feedback during the

Lamfalussy process; interested parties may wish to provide their initial comments to trade organisations who will, we assume, be lobbying EU institutions for the reform of the Proposal. In the interim, there is scope for substantial changes to the Proposal, and the final content of any legislation may be substantially different from the current draft. If the Directive proceeds smoothly to finalisation this year, Member States are expected to have until 2011 to implement it into national legislation. Until the final requirements and scope of the proposed new regulatory system reaches something closer to its final form, attempting to implement systems for compliance would probably be premature.

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