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■ PROPOSAL FOR EU DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS

Publication of draft Directive and implementation date

The EU Commission has published a draft directive on entities involved in the management and administration of alternative investment funds. Subject to approval of the final form of the Directive by the end of 2009, the Commission believes that it could come into force in 2011.

Scope of the Directive

Alternative investment funds

All funds, both EU and non-EU domiciled, which are not within the scope of the UCITS Directive, are caught, including:

- hedge funds and funds of hedge funds;
- private equity funds;
- real estate funds;
- commodity funds;
- infrastructure funds; and
- other types of institutional funds.

However, the Directive focuses on regulating the managers of alternative investment funds rather than regulating the funds directly.

Managers of alternative investment funds

The Directive will require the authorisation of *all managers established in the EU*, with the exception of:

- those managing fund portfolios with total assets of less than €100 million;
- those managing fund portfolios with total assets of less than €500 million, provided the funds are unleveraged and have lock-in periods of at least 5 years; and
- those which (i) do not provide management services to EU domiciled funds and (ii) do not market EU or non-EU domiciled funds within the EU.

Three years after the coming into force of the Directive, *managers established in non-EU countries* (“third countries”) may be authorised by an EU Member State to market EU and non-EU domiciled funds to professional clients, as defined by MiFID (i.e. institutional and sophisticated/high net worth investors), if:

- the EU Commission deems that the third country has equivalent regulatory standards and provides comparable “market access” to EU managers;

- there is a co-operation agreement between the third country and Member State regulators;
- there is an information exchange agreement on tax matters between the third country and the Member State; and
- the Member State regulator is provided with information on the manager and the fund(s).

During the three-year transitional period, EU Member States may allow or continue to allow managers to market the funds subject to national law.

The Directive does not appear to impose any requirements on third country managers who manage EU domiciled funds but do not market those funds within the EU.

The provisions on the marketing of funds within the EU by non-EU managers may have far-reaching implications. The definition of “marketing” under the Directive encompasses public offers and private placements, conducted both on a solicited and unsolicited basis. Therefore, if a third country manager (e.g. a manager based in the United States or Switzerland) wished to carry out any sales of funds to professional investors within the EU, the EU Commission must first deem that the third country’s regulations are equivalent to those in the EU and that EU managers have comparable access to the third country’s market. These requirements could have a protectionist effect.

Requirements for authorisation and operating conditions applicable to managers

All managers will have to obtain authorisation from the regulator in their home Member State. A two-month application process is envisaged. Managers will be required to:

- demonstrate that they are qualified to provide management services;
- provide detailed information on:
 - the planned activity of the manager;
 - the funds managed;
 - the governance of the manager (including any delegation arrangements);
 - internal procedures with respect to risk management, liquidity management, conflicts of interest, valuation and custody of assets, and regulatory reporting;

- meet minimum capital requirements (the higher of (i) €125,000 plus 0.02% of assets under management exceeding €250 million and (ii) the capital required to be held under the Capital Adequacy Directive);
- appoint an independent valuer of the funds and ensure that the fund is valued at least once a year (or on each dealing day if more frequent);
- appoint an EU-credit institution as an independent depositary;
- seek the prior authorisation of its home regulator, if it wishes to delegate one or more of its functions to third parties. Portfolio or risk management responsibilities may only be delegated to other authorised managers. Many managers currently retain non-EU based sub-investment managers (for example, a Hong Kong-based manager to manage an Asia-Pacific mandate). Such arrangements would not appear to be permitted by the Directive; and
- publish an annual report and audited financial statements relating to each fund.

Managers must notify their home regulator of any material changes to the information provided in their original application, including:

- changes to the investment strategy of a fund;
- changes to the constitutive documents of a fund; and
- the identity of any additional funds they intend to manage.

After the notification, the regulator has one month to approve, impose restrictions or reject the proposed changes.

Managers will also be required to report to their home regulator on a regular basis on the principal markets and instruments in which they trade, their principal exposures, performance data, concentrations of risk and levels of liquidity.

Managers employing leverage on a systematic basis (i.e. where leverage exceeds the equity capital of the fund in two out of the preceding four quarters) will be required to disclose the levels and sources of leverage to their home regulator. The EU Commission and national regulators will also be able to impose leverage limits applying generally or to specific funds/managers.

Requirements applicable to depositaries

The requirements applicable to depositaries retained by authorised managers may be

problematic. Firstly, depositaries are required to be EU credit institutions and many depositaries are not EU credit institutions. Secondly, the standard of care of depositaries provided for by the Directive is noteworthy. Under the UCITS Directive, a depositary is liable for its unjustifiable failure to perform its obligations or its improper performance of them. However, under the Directive for alternative investment fund managers, the standard appears to be higher: a depositary shall be liable for any losses suffered as a result of its failure to perform its obligations. In the case of any loss of financial instruments which the depositary safe-keeps, the depositary can only discharge itself of its liability if it can prove that it could not have avoided the loss which has occurred. This appears to impose a strict liability standard on the depositary for the safe-keeping of financial instruments. If this is the case, this could substantially raise the costs and risks borne by fund depositaries.

Effect of authorisation as a manager

Managers will be able to market funds to professional investors in the EU

Authorisation will entitle the manager to market the funds to professional clients only, as defined by MiFID (i.e. institutional and sophisticated/high net worth investors). Subject to a 10-day notification process, managers will be able to market the funds in other EU Member States.

Certain funds covered by the Directive (e.g. funds of hedge funds and open-ended real estate funds) have, to date, been open to investment by retail investors in individual Member States. The Directive permits a Member State to continue to allow for this but such funds may not be passported into other Member States under the Directive.

Managers will be able to provide management services to funds in other EU Member States

Subject to a 10-day notification process, the Directive provides that authorised managers may provide management services in relation to funds domiciled in another Member State either directly or via the establishment of a branch.

Given the experience with the passporting of UCITS funds into other Member States and the controversy surrounding the UCITS management company passport, it will be interesting to see whether the proposed 10-day notification process will be modified in the final Directive and how it will operate in practice.

Managers will be permitted to manage and market funds domiciled in non-EU countries

The Directive provides for a passport enabling managers to market non-EU funds to professional

investors in Europe three years after the coming into force of the Directive, provided that, among other things, there is an information exchange agreement on tax matters between the third country and the Member State. During the three-year transitional period, Member States may allow or continue to allow managers to market such funds to professional investors on their territory subject to national law.

Managers may delegate administration (but not management) functions to offshore entities subject to strict requirements in relation to regulation, supervision and co-operation, including the requirement that:

- the depositary is an EU credit institution. It may appoint sub-custodians in the third country if the sub-custodian is deemed by the EU Commission to be subject to equivalent regulation; and
- the valuer is independent and deemed by the EU Commission to be subject to equivalent valuation and regulatory standards.

Information to be provided to investors in alternative investment funds

Information to be provided prior to investment and on an ongoing basis

Managers must provide to investors a clear description of:

- the investment policy of the fund, including descriptions of the asset types and leverage;
- the redemption policy in normal and exceptional circumstances;
- the valuation, custody, administration and risk management procedures;
- fees, charges and expenses;
- the fund's liquidity profile; and
- any preferential treatment obtained by particular investors, including the identity of the investor. This latter requirement may affect "side-letter", rebating and similar arrangements.

Information requirements specific to private equity and buy-out funds

The Directive also provides for disclosures of information to shareholders and employee representatives of portfolio companies, in which managers acquire a controlling interest (i.e. 30% or more of the voting rights).

The Directive does not extend these requirements to acquisitions of control in SMEs (i.e. those

employing less than 250 people, having an annual turnover of less than €50 million and/or having an annual balance sheet of less than €43 million).

To meet concerns about reduction in information following the delisting of public companies by private equity owners, the Directive requires that such delisted companies continue to be subject to reporting obligations for listed companies for up to 2 years following delisting.

Conclusion

The Directive is wide in its scope and applies to managers of all non-UCITS funds (not just hedge funds and private equity funds) domiciled within and outside EU. The EU Commission expects the Directive to cover:

- 30% of hedge fund managers, managing 90% of assets of EU domiciled hedge funds; and
- 50% of the managers of other non-UCITS funds.

All managers, established both within and outside the EU, involved in the management and/or marketing of funds within the EU should carry out an assessment of its potential impact. There are many potential challenges. Non-EU managers may not be authorised to market funds within the EU if the EU Commission deems that their home jurisdiction does not have equivalent regulatory standards and does not provide comparable market

access to EU managers. As noted above, the definition of “marketing” under the Directive is broad and includes private placements, both on a solicited and unsolicited basis. The Directive also applies to the delegation arrangements between managers and other service providers. For example, authorised managers will only be able to delegate investment management functions to other entities that are authorised under the Directive. In addition, the Directive appears to impose strict liability on depositaries for the safe-keeping of financial instruments. This is a higher standard than that required of depositaries to UCITS funds.

The Directive may be seen as potentially damaging to offshore jurisdictions. Ireland, with its successful qualifying investor fund product (QIF), is already a jurisdiction of choice for regulated hedge funds and may benefit from the trend to move alternative investment funds onshore. One of the other benefits of the Directive for regulated managers/products like the QIF will be the ability to market alternative investment funds to professional investors throughout the EU. Given the varying and complex private placement rules within the EU, the move to a simplified notification process would be a positive one.

It is expected that the Directive will be the subject of much negotiation at a political level over the coming months and it remains to be seen how much the draft will evolve before it is adopted in final form.

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