

## Client Memorandum

### Proposed European Union Directive on Alternative Investment Fund Managers

July 15, 2009

The European Commission released a proposed draft Directive on Alternative Investment Fund Managers (the "Directive") on April 30, 2009.<sup>1</sup> Although the Directive seeks to regulate investment managers in the European Union ("EU"),<sup>2</sup> if implemented in its current form, it will have dramatic effects on any investment manager seeking to manage or market investment funds in the EU.

The Directive requires authorization of managers in the EU providing management services to "alternative investment funds" including hedge funds, real estate funds, private equity funds, non-UCITS regulated funds and fund of hedge funds.<sup>3</sup> The Directive subjects such managers to certain operational,<sup>4</sup> organizational<sup>5</sup> and capital requirements.<sup>6</sup>

Although the Directive does not seek to regulate investment funds directly, its provisions indirectly subject funds managed by authorized managers to several regulatory requirements, including certain requirements that would significantly change industry practice and increase the cost structure of investment management businesses. The Directive also includes several inherently protectionist provisions which severely limit the ability of authorized managers (and the funds they manage) to select non-EU service providers<sup>7</sup> and reduce investor choice by significantly limiting the marketing of both non-EU funds and funds managed by non-EU managers.<sup>8</sup>

#### *Regulatory Requirements*

The Directive includes the following significant regulatory requirements:

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<sup>1</sup> Schulte Roth & Zabel hosted an Audio Conference analysing the Directive on May 8, 2009. A webcast of the Audio Conference is available to clients upon request. Please contact your primary Schulte Roth & Zabel contact.

<sup>2</sup> The current Member States of the EU include Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom.

<sup>3</sup> See "Scope of the Directive" at page [3](#).

<sup>4</sup> See "Operating Conditions" at page [4](#).

<sup>5</sup> See "Organizational Requirements" at page [6](#).

<sup>6</sup> See "Capital Requirements" at page [5](#).

<sup>7</sup> See "Table 1 – Permitted Service Providers for Authorized Managers" at page [8](#).

<sup>8</sup> See "Table 2 - Summary of Directive's Marketing Provisions" at page [11](#).

- An independent “depository” authorized as a credit institution in the EU to hold fund assets<sup>9</sup>
- An independent “valuator” to value fund assets once a year (and whenever the fund issues or redeems shares)<sup>10</sup>
- Limits on (and disclosure of) leverage<sup>11</sup>
- Extensive disclosure to investors and regulatory authorities<sup>12</sup>
- Prohibition of 'naked' short sales<sup>13</sup>
- Disclosure of preferential treatment given to investors including the identify of such investors<sup>14</sup>
- Limits on the types of securitization products a fund may acquire<sup>15</sup>
- Additional requirements regarding conflicts of interest, risk management and liquidity management<sup>16</sup>

In addition to the requirements specifically included in the Directive, most of the Directive's provisions give the European Commission the power to promulgate additional restrictions.<sup>17</sup>

### *Pan-European Marketing*

In addition to the requirements the Directive places on investment managers (and derivatively on the funds they manage), the Directive includes a pan-European marketing regime for funds managed by authorized managers. Specifically, the Directive allows authorized managers to market the funds they manage to “professional investors” throughout the EU, allowing such funds to avoid the 27 country-specific private placement regimes currently in place in the EU (many of which severely limit or prohibit the offer and sale of investment funds).<sup>18</sup>

Unfortunately, the Directive's pan-European marketing regime is not available for at least three years with respect to (i) Cayman Island and other non-EU domiciled funds (e.g., funds domiciled in the British Virgin Islands, Bermuda or the Channel Islands) or (ii) to funds managed by US and other non-EU domiciled managers (e.g., managers domiciled in Switzerland, Japan or Hong Kong).<sup>19</sup>

With respect to non-EU domiciled managers, the Directive is ambiguous as to whether funds managed by such managers will have the ability to market as they do today under the existing country-specific private placement regimes. If not, funds managed by US and other non-EU domiciled managers could be prohibited from marketing or otherwise selling their shares in Europe for at least three years and indefinitely if their jurisdiction of domicile does not satisfy several requirements for third-country authorization.<sup>20</sup>

### *Timetable*

The European Commission expects political approval of the Directive by the end of 2009 and implementation of its provisions into the laws of each Member State in 2011.<sup>21</sup> Managers providing management services in

<sup>9</sup> See "Organizational Requirements – Depository" at page [6](#).

<sup>10</sup> See "Organizational Requirements – Valuation" at page [6](#).

<sup>11</sup> See "Leverage" at page [9](#).

<sup>12</sup> See "Transparency Requirements" at page [8](#).

<sup>13</sup> See "Operating Conditions – Risk Management – Prohibited Short Sales" at page [5](#).

<sup>14</sup> See "Transparency Requirements" at page [8](#).

<sup>15</sup> See "Operating Conditions – Limits on Investments in Securitization Products" at page [5](#).

<sup>16</sup> See "Operating Conditions" at page [5](#).

<sup>17</sup> The Explanatory Memorandum released with the draft Directive indicates that the European Commission expects to use these powers to implement restrictions targeted at the Managers of specific types of Funds.

<sup>18</sup> See "Marketing – Authorized EU Managers" at page [11](#).

<sup>19</sup> See "Marketing – Third-Country (Non-EU) Managers" at page [12](#).

<sup>20</sup> See "Marketing – Third-Country (Non-EU) Managers – Third-Country Authorization" at page [12](#).

<sup>21</sup> See "Timetable for Implementation of the Directive" at page [13](#).

the EU will likely be required to register (and begin complying with the Directive's requirements) within one year of its implementation.

### *Summary*

Many of the provisions in the Directive merely require the implementation of industry best practice. At the same time, if many of the other requirements are not changed to reflect the realities of the fund management industry and eliminate inherent protectionism, increased costs could make the management of funds from the EU uneconomical for many managers and marketing of investment funds in the EU managed by US and other non-EU domiciled managers much more difficult, if not impossible.

This briefing note summarizes the draft Directive, noting the consequences to investment managers, investment funds and investors, with a specific focus on the uncertainties for US and other non-EU domiciled managers.

### **Scope of Directive**

#### *Manager Authorization*

The Directive seeks to regulate investment managers ("Managers") domiciled in the EU that provide management services to "alternative investment funds" (irrespective of the domicile or structure of such funds) by requiring such Managers to obtain authorization from their local EU "home Member State" regulator ("Local Regulator").<sup>22</sup>

The Directive broadly defines an "alternative investment fund" as any collective investment undertaking that does not require authorization as a UCITS (a "Fund," and collectively "Funds").<sup>23</sup> As drafted, the Directive therefore takes a 'one-size-fits-all' approach to the regulation of Managers managing Funds as divergent as hedge funds, real estate funds, private equity funds, non-UCITS regulated funds and funds of hedge funds.<sup>24</sup>

Given that the Directive seeks to regulate managers of "collective investment undertakings," the current draft of the Directive would not seem to regulate Managers solely managing segregated managed accounts for individual clients, but would require authorization for a group of entities with identical ownership investing in a pooled vehicle.

The Directive also broadly defines "management services" as the "managing and administering" of a Fund. While this definition would seem to imply that EU domiciled fund administrators would need to seek authorization under the Directive, the Directive is ambiguous with respect to whether EU domiciled entities providing research or marketing services would be required to seek authorization under the Directive.<sup>25</sup>

#### *Exemptions from Authorization*

***De Minimis Exemption:*** The Directive provides *de minimis* exceptions from authorization for Managers that directly or indirectly manage Funds with aggregate assets (including assets acquired by leverage)<sup>26</sup> less than (i) €100 million or (ii) €500 if the Funds managed do not (1) utilize leverage or (2) grant redemption rights for the Fund's initial five years. This latter exception provides limited relief to Managers of private equity Funds

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<sup>22</sup> In the United Kingdom, the Local Regulator will likely be the Financial Services Authority (FSA).

<sup>23</sup> The Directive specifically excludes Funds requiring authorization pursuant to Article 5 of Directive 2009/.../EC (the UCITS Directive).

<sup>24</sup> The Explanatory Memorandum to the Directive indicates that the European Commission expects to promulgate additional restrictions tailored to Managers of specific types of Funds.

<sup>25</sup> An initial draft of the Directive leaked to the public prior to the official draft of the Directive included "marketing" in the definition of "management services". Its removal suggests that an entity solely marketing a Fund – whether domiciled in the EU or not – is not required to register under the Directive. That said, an unauthorized Manager will not be able to take advantage of the Directive's pan-European marketing provisions.

<sup>26</sup> The Directive broadly defines "leverage" to include any method of increasing exposure of a Fund to an investment whether by borrowing cash or securities, using derivative positions or any other means.

and other similar closed-end Funds. The Directive does not, however, indicate how the *de minimis* exceptions will be measured, given that the value of Fund assets fluctuates over time.

**Non-EU Fund Exemption:** The Directive provides an exemption from authorization for EU domiciled Managers which neither manage Funds domiciled in the EU nor market Funds in the EU.

**EU Credit Institution Exemption:** The Directive provides an exemption from authorization for "credit institutions" authorized as such in the EU.<sup>27</sup> This exemption essentially allows EU banks (and indirectly the Funds they manage) to avoid the requirements of the Directive, despite the fact they would in many instances be conducting identical activities.

**Other Exemptions:** The Directive also provides exemption from authorization for (i) Managers authorized under the UCITS Directive, (ii) certain institutions covered by EU Directives for pensions, insurance or reinsurance and (iii) supranational institutions such as the World Bank, the IMF and other organizations.

### *Authorization Procedures*

**Application:** A Manager applying for authorization under the Directive must provide an application to its Local Regulator including detailed information regarding the following:

- Owners of the Manager
- Activities of the Manager including how it intends to comply with certain provisions of the Directive
- Funds the Manager intends to manage
- Delegation of management services to third parties
- Arrangements made for the safe-keeping of Fund assets

**Approval of Authorization:** The Local Regulator must grant (or refuse) authorization within two months of receiving a completed application, but it may restrict the type of Funds a Manager is authorized to manage and limit its delegating arrangements.

**Changes to Authorization:** An authorized Manager must notify the Local Regulator of any changes to the information provided in the original application, including changes in the Funds it manages. The Local Regulator must grant (or refuse) authorization for such changes within one month of receiving notice of the changes.

## **Operating Conditions**

### *Conduct of Business*

The Directive imposes a duty on authorized Managers to act honestly, fairly, with due skill, care and diligence, and in the best interests of the Funds it manages, the investors in such Funds and the integrity of the market. The Directive also requires authorized Managers to ensure that all investors are treated fairly and that no investor is granted preferential treatment unless disclosed in the Fund's governing documents.<sup>28</sup>

### *Conflicts of Interest*

The Directive requires authorized Managers to identify conflicts of interests between (i) the Manager and investors in the Funds it manages and (ii) between the investors themselves. Once such conflicts are identified the Manager must take all reasonable steps to prevent such conflicts from adversely affecting the interests of the Funds and their investors and must provide full disclosure of those conflicts which cannot be prevented.

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<sup>27</sup> The Directive specifically refers to credit institutions authorized pursuant to Directive 2006/48/EC of the European Parliament and the Council of 14 June 2006.

<sup>28</sup> In addition to disclosure in a Fund's governing documents of the ability of the Fund to grant preferential treatment to individual investors, the Directive requires authorized Managers to disclose to potential investors whenever an investor has actually been granted preferential rights, the rights granted and the identity of such investor. See "Transparency Requirements – Disclosure to Investors" at page 8.

## *Risk Management*

**Required Risk Management Systems:** The Directive requires authorized Managers to internally separate risk management and portfolio management functions. The Directive also requires authorized Managers to implement and annually review risk management systems to measure and monitor all risks associated with each Fund it manages. The risk management systems must (i) include a due diligence process for making investments, (ii) ensure that the risks of each investment, and its overall effect on a Fund's portfolio, are identified, measured and monitored and (iii) ensure that the risk profile of the Fund corresponds to the size, portfolio structure and investment strategies of the Fund.

**Prohibited Short Sales:** As part of the Directive's required risk management procedures, an authorized Manager must have access to securities when it commits to deliver such securities on behalf of a Fund, thereby prohibiting authorized Managers from engaging in 'naked' short sales of securities on behalf of the Funds it manages.

## *Liquidity Management*

The Directive requires authorized Managers to ensure that the liquidity profile of a Fund's investments complies with its underlying obligations, to conduct stress tests and to otherwise monitor liquidity risk. The Directive also requires authorized Managers to ensure that each Fund it manages has a redemption policy appropriate to the liquidity profile of the Fund's investments.

In addition, the European Commission has reserved the right in the Directive to adopt measures specifying the minimum liquidity requirements for Funds managed by authorized Managers which redeem shares more frequently than half-yearly. It is unclear from the Directive whether the European Commission will utilize this power to specify acceptable liquidity terms or otherwise limit the types of liquidity controls (e.g., gates, suspensions, withdrawal fees) available to a Fund.

## *Limits on Investments in Securitization Products*

Although the Directive does not set forth specific requirements regarding securitization products, it indicates that the European Commission will adopt certain minimum requirements for securitization products for a Fund managed by an authorized Manager to invest in such products. The Directive indicates that these requirements will include both qualitative requirements and a requirement that the originator of a securitization retain a net economic interest of at least 5%.

## **Capital Requirements**

The Directive requires authorized Managers to maintain a minimum capitalization of the greater of (i) €125,000 plus an additional amount equal to 0.02% of the amount by which the aggregate net assets under management exceed €250 million and (ii) 25% of the Manager's annual expenses. Thus, an authorized Manager managing Funds with aggregate net assets of €1 billion would be required to have a total capitalization of €275,000 unless its annual expenses are greater than €1,100,000, in which case, it would be required to have a minimum capitalization of 25% of its annual expenses.

In determining the aggregate net assets under management, the Directive requires authorized Managers to include the net assets of those Funds the Manager manages directly, Funds the Manager manages by delegation, and Funds for which the Manager has itself delegated management authority to a third party.<sup>29</sup>

The Directive does not require a minimum capitalization for Funds.

## **Organizational Requirements**

### *General Principles*

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<sup>29</sup> For more information on an authorized Manager's ability to delegate to subadvisers see "Delegation of Manager Functions" at page [7](#).

The Directive requires authorized Managers to have adequate resources at all times, including updated systems, documented internal procedures and regular internal controls.

### *Valuation*

The Directive requires authorized Managers to appoint an independent "valuator" for each Fund it manages to value the assets and the shares of the Funds it manages.<sup>30</sup> Such valuations must be performed at least once a year and each time shares are issued or redeemed. The Directive also requires authorized Managers to ensure the valuator has appropriate and consistent procedures for the valuation of assets.

The Directive's valuation requirements apply to all Funds managed by an authorized Manager including private equity funds for which such valuations may not be particularly relevant. As a result, the Directive may result in valuations being performed in many cases by a valuator that knows less about the asset being valued than the Manager and for little if any benefit to investors.

An authorized Manager cannot appoint a non-EU domiciled valuator until three years after the date on which each Member State is obliged to implement the terms of the Directive into its own laws and regulations (the "Transposition Date"),<sup>31</sup> and then only if the European Commission determines that the valuation standards in the valuator's jurisdiction are equivalent to those in the EU.

### *Depositary*

Independent Depositary: The Directive requires authorized Managers to appoint an independent "depositary" for each Fund it manages to (i) receive and book subscription payments, (ii) safe-keep the financial instruments of the Fund and (iii) verify ownership of all other Fund assets. The depositary must act solely in the interest of Fund investors which requires the depositary to take on broader functions than a traditional custodian or prime broker and raises questions about whether re-hypothecation of assets will continue to be possible under the Directive.

Like the requirement for an independent valuator, the Directive's depositary requirements apply to all Funds managed by an authorized Manager, including private equity funds for which custody of assets has not necessarily been an issue. Moreover, given that some existing Funds may require investor consent to engage a new depositary, some managers may not be able to comply with the depositary requirements for Funds they currently manage.

EU Credit Institution: The depositary must be an EU-authorized credit institution, limiting the current number of potential depositaries to a few EU domiciled financial institutions. Given that many prime brokers in the EU are neither authorized credit institutions nor have an EU authorized credit institution in their group, many Funds will need to reorganize their prime brokerage relationships if the Directive is implemented in its current form.

Limited Delegation to Sub-custodians: The depositary may delegate its depositary functions to another authorized EU credit institution and, beginning three years after the Transposition Date,<sup>32</sup> to sub-custodians domiciled in the same country as the Fund (and nowhere else) if the European Commission has determined that the jurisdiction of the sub-custodian (i) has effectively enforced local legislation regarding depositaries, (ii) cooperates with the Member State where the Manager is established and (iii) has equivalent local anti-money laundering standards.

Custodians generally appoint sub-custodians in the country in which the issuer of a security is incorporated and, in some jurisdictions, title to securities must be held by a local sub-custodian. As a result, the limits the

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<sup>30</sup> The Directive indicates that European Commission must further specify the criteria for independence.

<sup>31</sup> The European Commission's proposed timetable for implementation of the Directive indicates that the Transposition Date is unlikely to occur before 2014.

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Directive places on the depositary's domicile and its ability to delegate to sub-custodians could restrict the availability of certain assets to Funds managed by an authorized Manager.

These restrictions will also make it more difficult for a Fund managed by an authorized Manager to appoint multiple custodians, leading to an increased concentration of counter-party risk.

Liability of Depositary: The depositary essentially assumes a strict liability standard with respect to the custody of a Fund's assets, which will likely reduce the number of institutions willing to provide depositary services and, if any are willing to provide such services, increase the cost of such services for Funds managed by authorized Managers.<sup>33</sup> Specifically, the depositary is directly liable to both the Manager and Fund investors for any losses suffered as a result of failure by the depositary to perform its obligations. The depositary's liability is also unaffected by delegation to a sub-custodian and can only be avoided if the depositary can prove it could not have avoided the loss.

## **Delegation of Manager Functions**

### *General*

The Directive requires authorized Managers to seek prior authorization from their Local Regulator to delegate any of its functions. Under the Directive, the Manager's functions include managing and administering the Funds it is authorized to manage and, therefore, the Directive requires authorized Managers to seek prior authorization to delegate to subadvisers or administrators management or risk management functions to any entity not authorized under the Directive. For the Local Regulator to authorize the delegation of a Manager's functions, the Manager must demonstrate that the delegate is creditworthy and of sufficiently good repute and experience, and that the Manager can effectively monitor the functions delegated, give further instructions to the delegate and withdraw the delegation immediately if in the interest of Fund investors.

The Manager's liability to the Fund and Fund investors is unaffected by delegation to a subadviser or administrator. Moreover, the delegate may not sub-delegate any of the functions delegated to it to a third party.

### *Subadvisers*

The Directive prohibits delegation of portfolio or risk management functions to any entity not authorized under the Directive. As a result, EU domiciled Managers cannot delegate functions to US or other non-EU domiciled Managers, given that such Managers cannot be authorized under the Directive.<sup>34</sup>

### *Administrators*

In addition to the general requirements for delegation set forth above, an authorized Manager can only delegate "administrative services" to a non-EU administrator under the Directive beginning three years after the Transposition Date,<sup>35</sup> and only then if that administrator is regulated and subject to supervision in its country of domicile and there is a cooperation agreement between the Local Regulator of the Manager and the regulator of the administrator.

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<sup>33</sup> A similar liability standard has recently been proposed as an amendment to the UCITS Directive for depositaries of UCITS-compliant funds.

<sup>34</sup> Although US and other Non-EU domiciled Managers may be authorized to market the interest of Funds in the EU, the Directive does not include a provision that would allow such a Manager to obtain authorization to perform "management services" under the Directive.

<sup>35</sup> The European Commission's proposed timetable for implementation of the Directive indicates that the Transposition Date is unlikely to occur before 2014.

**Table 1—Permitted Service Providers for Authorized Managers**

<u>Service Provider</u>	<u>EU Domiciled Fund</u>	<u>Non-EU Domiciled Fund</u>
<b>Subadviser</b>	Yes, if subadviser authorized under the Directive	No, an authorized Manager cannot delegate portfolio management or risk management services to an unauthorized subadviser (and non-EU domiciled subadvisers cannot be authorized under the Directive)
<b>Administrator</b>	Yes	Not until at least 2014 and then only if the Manager receives approval from the Local Regulator that the administrator is (i) regulated and subject to prudential supervision in its country of domicile and (ii) there is a cooperation agreement between the Local Regulator of the Manager and the regulator of the administrator
<b>Valuator</b>	Yes	Not until at least 2014 and then only if the European Commission determines that the valuation standards in the valuator's jurisdiction are equivalent to those in the EU
<b>Depository</b>	Yes, but only if depository an EU authorized credit institution	No
<b>Subcustodian</b>	Yes, but only if depository an EU authorized credit institution	No, for an EU domiciled Fund  Not until at least 2014 for non-EU domiciled Funds and then only] a subcustodian in the jurisdiction of the Fund and if the European Commission has determined that the jurisdiction of the sub-custodian (i) has effectively enforced local legislation regarding depositaries, (ii) cooperates with the Member State where the Manager is established and (iii) has equivalent local anti-money laundering standards

**Transparency Requirements***Disclosure to Investors*

The Directive requires authorized Managers to provide a minimum level of disclosure to investors prior to the sale of an interest in a Fund. Although much of the required disclosure would be part of a well-drafted offering document (and indeed part of the best practices set forth by several industry self-regulatory organizations), the Directive also requires disclosure of specific valuation methods and pricing models used to value assets and the identity of, and the rights granted to, any investor granted preferential treatment through side letters or other arrangements. In addition, the Directive indicates that the European Commission must adopt additional disclosure requirements adapted to different types of Managers and the Funds they manage.

*Disclosure to Local Regulator*

The Directive requires an authorized Manager to regularly provide its Local Regulator with "aggregated information" regarding the principal markets and instruments in which it trades and the principal exposures and important concentrations of each Fund it manages. The Directive also requires authorized Managers to periodically provide the Local Regulator with information regarding the percentage of a Fund's assets subject to "special arrangements" arising from their illiquid nature and the risk profile of the Fund and the risk

management tools employed to manage these risks. Disclosure of the use of short selling during the reporting period is also required.

Unfortunately the key questions with respect to the disclosures to the Local Regulator – whether position level disclosure will be required and whether there will be public disclosure of such information – are unclear from the Directive.

## **Leverage**

### *Limits on Leverage*

The Directive requires the European Commission to impose leverage limits on Funds managed by authorized Managers to ensure the stability and integrity of the financial system. In setting limits on leverage, the European Commission will be required to take into account the type of Fund, its strategy and sources of leverage. The Directive also gives Local Regulators the power to impose additional temporary limits on leverage in exceptional circumstances to ensure the stability and integrity of the financial system.<sup>36</sup>

Although the limits on leverage are intended to ensure the stability and integrity of the financial system, it is unclear how imposing leverage limits on Funds managed by authorized Managers without imposing such a restriction on other market participants ensures the stability of the system as a whole.

### *Disclosure by Highly Leveraged Funds*

The Directive requires authorized Managers managing Funds employing "a high level of leverage on a systematic basis" to disclose to investors the maximum level of leverage, any rights granted with respect to the re-use of collateral and, on a quarterly basis, the total amount of leverage employed by the Fund in the preceding quarter. Such Managers are also required to regularly disclose to that Local Regulator the level and type of leverage employed and the identity of the five largest sources of borrowed cash and securities for each Fund managed.<sup>37</sup>

The Directive indicates that a Fund will be deemed to be using "a high level of leverage on a systematic basis" if its leverage exceeds the value of its equity capital in two of the previous four quarters. The Frequently Asked Questions released by the European Committee with the Directive referred to a recent Alternative Investment Management Association report indicating that the average level of leverage employed by hedge funds is one times the value of net assets. As a result, the European Committee seems to expect that the majority of Funds will be subject to these additional disclosure requirements.

## **Funds with a Controlling Influence**

The Directive imposes additional disclosure requirements on authorized Managers which acquire a controlling influence in EU companies, such as those managing private equity or activist funds. A Manager is deemed to have acquired a "controlling influence" in a company if it manages Funds which (i) in the aggregate, account for 30% or more of the voting rights of a company domiciled in the EU or (ii) has an agreement with other managers which would allow the Funds managed by such Managers to acquire an aggregate of 30% or more of the voting rights of a company domiciled in the EU. The Directive includes an exception with respect to small- to medium-sized companies which employ less than 250 persons, have an annual turnover of less than €50 million or have total assets less than or equal to €43 million.

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<sup>36</sup> Bloomberg has reported that, in keeping with a suggested European Union Directive, the United Kingdom plans to give the Financial Services Authority (FSA) emergency powers to cut individual hedge funds' leverage, but it remains opposed to the majority of the Directive, including the introduction of limits on leverage. Minister Paul Myners recently stated "[w]e will ensure [the FSA] has the powers to intervene directly with managers to prevent the build-up of excessive leverage wherever this is justified."

<sup>37</sup> The frequency of such disclosures is to be determined by the European Commission.

## Disclosure Requirements

**Listed Companies:** The Directive requires authorized Managers that have acquired a controlling influence in a listed company to provide the following to the company, its shareholders and employees:

- Certain information required in an offering document to the stakeholders of a target company under the EU Directive on Takeovers<sup>38</sup>
- A policy for preventing and managing conflicts of interest (including those between the Manager and the company)
- A communication policy with respect to the company's stakeholders (including its employees)

**Non-Listed Companies:** The Directive requires authorized Managers that have acquired a controlling influence over a non-listed company to provide to the company and its shareholders the terms of the voting rights held, and the conditions by which the 30% threshold was reached (including the identity of the different shareholders involved). In addition, the Directive requires authorized Managers to provide the following to the company, its shareholders and its employees:

- The identity of the Manager which either individually or in agreement with other Managers reached the 30% threshold
- A development plan for the company
- A policy for preventing and managing conflicts of interest (including those between the Manager and the company)
- A communication policy with respect to the companies stakeholders (including its employees)

**Additional Disclosures:** In addition to the disclosures above, the Directive requires a Manager to include detailed information about the activities and financial affairs of each company for which it acquires controlling influence (i) in the annual report of each Fund it manages and (ii) to the employees of the company concerned.<sup>39</sup>

Although the disclosure obligations are extensive, of particular concern is the requirement for addressing conflicts of interest between the company and the Manager, as this requirement suggests that Managers owe duties to the companies in which they invest, in addition to the Manager's duties to the Funds it manages.

## Marketing

Currently, many of the 27 Member States in the EU significantly restrict or prohibit marketing of Funds. The Directive would significantly change the existing practice of marketing funds under the existing country-specific private placement regimes, and instead allow authorized Managers to market the Funds they manage to "professional investors" on a pan-European basis (including in Member States that currently prohibit marketing of such Funds). The Directive also gives individual Member States the authority to allow authorized Managers to market to "retail investors" within the individual Member State.<sup>40</sup>

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<sup>38</sup> The Directive specifically requires providing the information referred to in Article 6(3) of Directive 2004/25/EC of European Parliament and the Council of 21 April 2004 on takeover bids.

<sup>39</sup> The required information includes: (i) a summary of the operational and financial developments, (ii) a presentation of revenue and earnings by business segment, (iii) a statement on the progress of the company's activities and financial affairs, (iv) a report on significant events in the financial year, (v) a statement of financial risks associated with capital structure, (vi) data on turnover, terminations and recruitment of employees, (vii) a statement on significant divestment of assets, (viii) (in respect of listed companies) the composition and operation of the administrative, management and supervisory bodies, details relating to the capital structure, and the holders of any securities with specific control rights and a description of those rights and (ix) (in respect of unlisted companies) an overview of the management arrangements, the number of shares subscribed, the rights attaching to each share, any provisions relating to conversion of shares, the amount of subscribed capital paid up at the time the company is incorporated or authorized to commence business, and the number of shares paid up other than in cash.

<sup>40</sup> Despite the potential benefits of the Directive's pan-European marketing provisions, it should be noted that the pan-European marketing passport under the UCITS Directive implemented in 1989 has yet to create one seamless European market for UCITS Funds.

The Directive defines "marketing" to mean any general offering or placement of shares in a Fund to investors domiciled in the EU regardless of at whose initiative the offer or placement takes place. As a result, responding to unsolicited approaches from investors will constitute marketing under the Directive.

In defining a "professional investor," the Directive refers to "professional clients" under the EU's MiFID Directive and therefore generally includes large institutional investors but excludes most high net worth individuals.<sup>41</sup>

**Table 2—Summary of Directive's Marketing Provisions**

	<u>EU Domiciled Fund</u>	<u>Non-EU Domiciled Fund</u>
<b>UK and Other EU Managers</b>	<u>Initial 3 Years</u>	<u>Initial 3 Years</u>
	Market to professional investors on a pan-European basis	Market to professional investors in home Member State and under other Member States' existing private placement rules
	<u>After 3 Years</u> Same as above	<u>After 3 Years</u> Market to professional investors on a pan-European basis if Non-EU Fund jurisdiction enters into effective tax sharing agreements
<b>US and other Non-EU Managers</b>	<u>Initial 3 Years</u>	<u>Initial 3 Years</u>
	Unclear whether a non-EU Manager can continue to market EU Funds under Member States' existing private placement rules <sup>42</sup>	Unclear whether a non-EU Manager can continue to market non-EU Funds under Member States' existing private placement rules
	<u>After 3 Years</u> Market to professional investors on a pan-European basis if non-EU jurisdiction of Manager satisfies requirements for third-country authorization	<u>After 3 Years</u> Market to professional investors on a pan-European basis if (i) non-EU jurisdiction of Manager satisfies requirements for third-country authorization and (ii) non-EU jurisdiction of Fund enters into effective tax sharing agreements

### *Authorized EU Managers*

**EU Funds:** The Directive would allow an EU domiciled Fund (e.g., a fund domiciled in Ireland, Luxembourg or Malta) managed by an authorized Manager to be marketed to "professional investors" in any Member State in the EU upon prior notification to the Manager's Local Regulator.

**Non-EU Funds:** Beginning three years after the Transposition Date,<sup>43</sup> the Directive would allow a non-EU domiciled Fund (e.g., a fund domiciled in the Cayman Islands, the British Virgin Islands or Channel Islands) managed by an authorized Manager to be marketed to "professional investors" in any Member State in the

<sup>41</sup> "Professional clients" under the MiFID Directive include (i) authorized or regulated institutions such as credit institutions, investment firms, insurance companies and pension funds, (ii) large undertakings which satisfy two of the three financial tests (*i.e.*, €20 million balance sheet, €40 net turn over or €2 million of their own capital), (iii) national and regional governments, central banks, public bodies and international and supranational institutions such as the World Bank, the IMF, the ECB, the EIB and other similar organizations and (iv) other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitization of assets or other financing transactions. Under the MiFID Directive, Managers may be able to market to certain high net worth individuals if they are individually regulated or elect the status of "elective professional".

<sup>42</sup> The Directive is also unclear as to whether an EU domiciled Fund can be managed from outside the EU by an unauthorized Manager. If not, a non-EU domiciled Manager may be prohibited from managing or marketing an EU domiciled Fund.

<sup>43</sup> The European Commission's proposed timetable for implementation of the Directive indicates that the Transposition Date is unlikely to occur before 2014.

EU upon prior notification to the Manager's Local Regulator if the domicile of the Fund enters into an agreement complying with the OECD Model Tax Convention to share tax information with each Member State in which marketing is to take place.<sup>44</sup> Until 2014, each Member State may allow marketing of non-EU domiciled Funds by authorized Managers in accordance with its existing private placement regime.

### *Unauthorized EU Managers*

The Directive would allow Funds managed by unauthorized EU domiciled Managers (because they satisfy an exemption from authorization under the Directive) to continue to be marketed under existing country-specific private placement regimes.

### *Third-Country (Non-EU) Managers*

The Directive is unclear as to whether Funds managed by US or other non-EU domiciled Managers will continue to have the ability to market under Member States' existing private placement regimes after the Directive is implemented.

US and other non-EU domiciled Managers can potentially obtain the benefits of the marketing passport under the Directive if such Managers either (i) establish a subadviser in the EU authorized under the Directive or (ii) obtain third-country authorization.

Authorized EU Subadviser: The Directive would allow a US or other non-EU domiciled Manager to establish a subadviser in the EU which could obtain authorization under the Directive. As currently drafted, the Directive would seem to allow the Funds receiving management services from an authorized subadviser to be marketed to professional investors on a pan-European basis. However, the authorized subadviser would have to ensure that the Funds to which it provides management services comply with the terms of the Directive including the leverage limits and the requirements for an independent depository, an independent valuator and transparency to investors and regulators.<sup>45</sup>

Although the current draft of the Directive would appear to allow Funds with an unauthorized Manager and an authorized subadviser to be marketed under the Directive's pan-European marketing regime, such an arrangement seems contrary to the intent of the Directive's delegation provisions which provide that an authorized Manager may only delegate portfolio management and risk management services to other authorized Managers. As currently drafted, the Directive would appear to allow Funds managed by an unauthorized US Manager to take advantage of the Directive's marketing passport if an authorized EU subadviser provides minimal management services to the Fund.

Third-country Authorization: Beginning three years after the Transposition Date,<sup>46</sup> the Directive will allow Member States to authorize US and other non-EU Managers to market Funds in the EU under the Directive's marketing passport if (i) the European Commission determines that the US or other applicable third-country jurisdiction satisfies several legislative and information sharing requirements and (ii) the non-EU domiciled Manager provides the relevant Local Regulator<sup>47</sup> with all of the information required for authorization by an EU domiciled Manager.<sup>48</sup>

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<sup>44</sup> By requiring an agreement between the non-EU jurisdiction and each Member State, the Directive gives Member States the ability to effectively prohibit the marketing of non-EU domiciled Funds in their jurisdiction by not entering into such an agreement.

<sup>45</sup> With respect to typical US Manager with a London subsidiary office, the London office would be required to obtain authorization under the Directive if that office provides management services (either directly or indirectly as subadviser) to any of the US Manager's Funds. For the UK office to comply with the requirements for authorization under the Directive, all of the Funds to which the UK office provides management services will be required to comply with the requirements of the Directive (including the leverage limits and the requirements for an independent EU credit institution depository, an independent valuator and transparency to investors and the FSA). The resulting compliance costs will likely outweigh the benefits of such a London office, potentially prompting many US Managers to close their London operations.

<sup>46</sup> The European Commission's proposed timetable for implementation of the Directive indicates that the Transposition Date is unlikely to occur before 2014.

<sup>47</sup> The Local Regulator is the Member State in which it is applying for authorization.

<sup>48</sup> See "Scope of the Directive – Application Procedures" at page 3.

For a US or any other third-country jurisdiction to be approved for third-country authorization, the non-EU jurisdiction must satisfy the following requirements:

- Enact and enforce prudential regulation equivalent to the Directive<sup>49</sup>
- Allow EU Managers to market their funds in the non-EU jurisdiction on comparable terms to those allowed Managers in the EU under the Directive
- Enter into a cooperation agreement with the relevant Local Regulator ensuring exchange of all information relevant for monitoring systemic risk and the functioning of markets
- Enter into a tax information sharing agreement with the relevant Member State that complies with the OECD Model Tax Convention

The Directive provides that the European Commission will develop criteria for determining regulatory equivalence based on the specific requirements required of Managers authorized under the Directive. The criteria will therefore likely require the non-EU jurisdiction to have regulation that limits leverage and requires minimum regulatory capital, an independent custodian, an independent valuator and increased transparency to investors and regulators.

Whether the European Commission grants the US or other non-EU countries third-country authorization under the Directive will likely be a political process. Nonetheless, based on current regulation, agreements and legislative proposals, it seems unlikely that the US would satisfy the Directive's requirements for third-country authorization. First, although current legislative proposals in the US would expand regulation of investment advisors, the US is unlikely to enact legislation and promulgate regulation with equivalent leverage limits and equivalent requirements for regulatory capital, an independent depository and an independent valuator. Second, it seems unlikely that the European Commission will determine that the current US private placement rules allow Managers to market their Funds in the US on comparable terms to those allowed Managers under the Directive. Although the "accredited investor" standard under Regulation D of the US Securities Act of 1933 is generally equivalent to (and arguably more permissive than) the Directive's "professional investor" standard, Regulation D, unlike the Directive, prohibits 'general advertising' or 'general solicitation' to potential investors. The SEC has historically interpreted the prohibition on general advertising and general solicitation to require the issuer to have a substantive pre-existing relationship with potential investors—a significant restriction on marketing in the US for which there is no equivalent in the Directive.<sup>50</sup>

If the Directive prohibits Funds managed by US and other non-EU domiciled managers from marketing under existing Member States' private placement regimes and such non-EU jurisdictions are unable to obtain third-country authorization, the Directive will have the effect of substantially reducing the choice of Funds in which EU investors may invest. More importantly, the US may be inclined to retaliate with similar restrictions on EU Managers marketing in the US. The result would be mutually exclusive US and EU markets for alternative investment Fund products, similar to the mutually exclusive US and EU markets for regulated Fund products.

### *Third-Party Marketers*

The Directive is silent with respect to marketing by third parties and it is therefore unclear whether a third party can market funds managed by authorized Managers to professional investors under the Directive.

### **Timetable for Implementation of the Directive**

The European Commission expects political approval of the Directive by the end of 2009 and implementation of its provisions into the laws of each Member State in 2011. The Directive will first be considered by the EU's

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<sup>49</sup> Although it is unclear in the Directive, it would seem a US or other non-EU domiciled Manager would need to be authorized to manage funds pursuant to the prudential regulation in the jurisdiction in which it is domiciled. In the US, this would mean registration as an investment adviser under the US Investment Advisers Act.

<sup>50</sup> It is potentially relevant to note that regulators in the US and the EU have been discussing reciprocal market access for US-regulated investment companies and EU-regulated UCITS funds for over 20 years.

Committee on Economic and Monetary Affairs and then by the European Parliament and the European Council of Ministers.

Those who wish to participate in the political process are encouraged to contact the [Alternative Investment Management Association](#).

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We will continue to monitor the progress of the proposed Directive, as well as the other regulatory reform initiatives currently under consideration, and will inform you of significant developments.

*Authored by Josh Dambacher.*

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If you have any questions concerning this Client Memorandum, please contact:

**Key London Contacts**

Josh Dambacher	+44 (0) 20 7081 8044	<a href="mailto:josh.dambacher@srz.com">josh.dambacher@srz.com</a>
Nick Fagge	+44 (0) 20 7081 8009	<a href="mailto:nick.fagge@srz.com">nick.fagge@srz.com</a>
Christopher Hilditch	+44 (0) 20 7081 8002	<a href="mailto:christopher.hilditch@srz.com">christopher.hilditch@srz.com</a>
Daniel Shapiro	+44 (0) 20 7081 8001	<a href="mailto:daniel.shapiro@srz.com">daniel.shapiro@srz.com</a>
Nick Terras	+44 (0) 20 7081 8003	<a href="mailto:nick.terras@srz.com">nick.terras@srz.com</a>
Kerrie Walsh	+44 (0) 20 7081 8008	<a href="mailto:kerrie.walsh@srz.com">kerrie.walsh@srz.com</a>

**Other Contacts**

Yehuda M. Braunstein	+1 212.756.2443	<a href="mailto:yehuda.braunstein@srz.com">yehuda.braunstein@srz.com</a>
Philippe Benedict	+1 212.756.2124	<a href="mailto:philippe.benedict@srz.com">philippe.benedict@srz.com</a>
Stephanie R. Breslow	+1 212.756.2542	<a href="mailto:stephanie.breslow@srz.com">stephanie.breslow@srz.com</a>
David M. Cohen	+1 212.756.2141	<a href="mailto:david.cohen@srz.com">david.cohen@srz.com</a>
Ida Wurczinger Draim	+1 202.729.7462	<a href="mailto:ida.draim@srz.com">ida.draim@srz.com</a>
David J. Efron	+1 212.756.2269	<a href="mailto:david.efron@srz.com">david.efron@srz.com</a>
Marc E. Elovitz	+1 212.756.2553	<a href="mailto:marc.elovitz@srz.com">marc.elovitz@srz.com</a>
Ron Feldman	+44 (0) 20 7081 8027	<a href="mailto:ron.feldman@srz.com">ron.feldman@srz.com</a>
Steven J. Fredman	+1 212.756.2567	<a href="mailto:steven.fredman@srz.com">steven.fredman@srz.com</a>
Dominique Padilla Gallego	+1 212.756.2332	<a href="mailto:dominique.gallego@srz.com">dominique.gallego@srz.com</a>
Kenneth S. Gerstein	+1 212.756.2533	<a href="mailto:kenneth.gerstein@srz.com">kenneth.gerstein@srz.com</a>
David S. Griffel	+1 212.756.2428	<a href="mailto:david.griffel@srz.com">david.griffel@srz.com</a>
Udi Grofman	+1 212.756.2298	<a href="mailto:udi.grofman@srz.com">udi.grofman@srz.com</a>
Peter J. Halasz	+1 212.756.2238	<a href="mailto:peter.halasz@srz.com">peter.halasz@srz.com</a>
Philip A. Heimowitz	+1 212.756.2583	<a href="mailto:philip.heimowitz@srz.com">philip.heimowitz@srz.com</a>
Daniel F. Hunter	+1 212.756.2201	<a href="mailto:daniel.hunter@srz.com">daniel.hunter@srz.com</a>
Jason S. Kaplan	+1 212.756.2760	<a href="mailto:jason.kaplan@srz.com">jason.kaplan@srz.com</a>
Karen Loga	+1 212.756.2156	<a href="mailto:karen.loga@srz.com">karen.loga@srz.com</a>
Kelli L. Moll	+1 212.756.2557	<a href="mailto:kelli.moll@srz.com">kelli.moll@srz.com</a>
David Nissenbaum	+1 212.756.2227	<a href="mailto:david.nissenbaum@srz.com">david.nissenbaum@srz.com</a>
Omoz Osayimwese	+1 212.756.2075	<a href="mailto:omoz.osayimwese@srz.com">omoz.osayimwese@srz.com</a>
Paul N. Roth	+44 (0) 20 7081 8047	<a href="mailto:paul.roth@srz.com">paul.roth@srz.com</a>
Jesse R. Rubin	+1 212.756.2450	<a href="mailto:jesse.rubin@srz.com">jesse.rubin@srz.com</a>
Phyllis A. Schwartz	+1 212.756.2504	<a href="mailto:phyllis.schwartz@srz.com">phyllis.schwartz@srz.com</a>
George M. Silfen	+1 212.756.2417	<a href="mailto:phyllis.schwartz@srz.com">phyllis.schwartz@srz.com</a>
Craig Stein	+1 212.756.2131	<a href="mailto:george.silfen@srz.com">george.silfen@srz.com</a>
Joseph Suh	+1 212.756.2390	<a href="mailto:craig.stein@srz.com">craig.stein@srz.com</a>
Shlomo C. Twerski	+1 212.756.2390	<a href="mailto:joseph.suh@srz.com">joseph.suh@srz.com</a>
Paul N. Watterson, Jr.	+1 212.756.2536	<a href="mailto:shlomo.twerski@srz.com">shlomo.twerski@srz.com</a>
Marc Weingarten	+1 212.756.2510	<a href="mailto:paul.watterson@srz.com">paul.watterson@srz.com</a>
	+1 212.756.2563	<a href="mailto:marc.weingarten@srz.com">marc.weingarten@srz.com</a>
	+44 (0) 20 7081 8048	
	+1 212.756.2280	

---

**London**

Schulte Roth & Zabel International LLP  
Heathcoat House  
20 Savile Row, London W1S 3PR  
+44 (0) 20 7081 8000  
+44 (0) 20 7081 8010 fax

**New York**

Schulte Roth & Zabel LLP  
919 Third Avenue  
New York, NY 10022  
+1 212.756.2000  
+1 212.593.5955 fax

**Washington, DC**

Schulte Roth & Zabel LLP  
11152 Fifteenth Street, NW, Suite 850  
Washington, DC 20005  
+1 202.729.7470  
+1 202.730.4520 fax

[www.srz.com](http://www.srz.com)

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