CADWALADER

Cadwalader, Wickersham & Taft LLP
New York London Charlotte Washington Beijing

Dashwood House
69 Old Broad Street, London, EC2M 1QS
Tel +44 (0) 20 7170 8700 Fax +44 (0) 20 7170 8600
DX: 516 (London City)
www.cadwalader.com

Clients&FriendsMemo

The Directive on Alternative Investment Fund Managers: Implications For Non-European Investment Managers

17 December 2010

A. The Directive

The Directive on Alternative Investment Fund Managers (the "**Directive**") is aimed, broadly, at two targets. Firstly, it requires the authorisation and supervision of all alternative investment fund managers ("**AIFM**") and imposes investor protection requirements on those authorised AIFM. These requirements include significant obligations to make disclosures to investors, regulators and target companies, obligations to deploy adequate risk management systems, obligations to appoint independent depositaries who bear a degree of legal liability to the investor, and leverage controls. Secondly, the Directive looks to create a truly borderless market across the EU to allow AIFM to "passport" their services throughout Europe once authorised in a single Member State. For the first time, these passports will (eventually) be available to non-EU persons. That means that, provided they comply fully with the Directive, AIFM who do not operate from a European place of business may obtain a passport that allows them to offer their services throughout Europe without seeking authorisation in each Member State into which they want to market their funds.

The scope of the Directive is broad. It applies at manager level, but not at fund level, and to all EU AIFM managing EU funds, EU AIFM managing non-EU funds, non-EU AIFM managing EU funds and non-EU AIFM marketing funds (EU or other) into Europe.[1] Article 3(1)(b) of the Directive gives a very wide definition of "alternative investment fund" as being "any collective investment undertaking...which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors, and...which does not require authorisation pursuant to...[the UCITS directive]". This means that, subject to a few rather limited exceptions,[2] the Directive applies to EU and non-EU managers of any non-UCITS collective investment vehicle, including hedge funds, private equity funds and real estate funds, that is sold into Europe.

---

1 See Article 2(1) of the Directive.

2 Article 2a(2) exempts funds with portfolios of less than EUR 100 million and those with portfolios of less than EUR 500 million that are not leveraged and cannot be redeemed within 5 years of the initial investment.

B. Timing

- The Directive's text was agreed in November 2010 and its official publication is likely to happen at the beginning of 2011.
- Domestic implementation of the Directive into national law and the introduction of the "passport" in Member States in 2013.
- The passport will not be available to non-EU AIFM until 2015, and will only become available should the European Securities and Markets Authority (ESMA)[3] recommend.
- Between 2015 and 2018 both national private placement regimes and the passport will be available for a "dual system period". In 2018 the European Commission may elect to end the national private placement regimes.

C. What Does Obtaining a Passport Mean For a Non-European AIFM?

Access to a passport for third country fund managers is a significant development, particularly given how tense debates around this issue have been since the Directive was first launched in 2009 and the level of resistance encountered from some countries. Some of the more difficult pre-conditions for access seen in previous discussion drafts have been dropped (reciprocal market access and an equivalent third country regulatory regime) but that does not mean that the passport comes without requirements that are going to need careful thought before a non-EU AIFM decides to apply.

Access to a passport requires full compliance with the Directive. This means full compliance with onerous disclosure requirements, putting in place risk management structures, subjection to new rules on remuneration[4], requirements for an independent depository[5] bearing a significant degree of legal liability, and leverage requirements including disclosures to regulators that may be used by those regulators to impose limits on levels of leverage employed by the AIFM. In addition, AIFM will be subject to the Directive's "sliding scale" capital requirements tied to the value of the funds under management and subject to a minimum and a "floor". For some funds, these capital requirements will represent a step-up in cash

---

[3] ESMA is the successor organisation to CESR (Committee of European Securities Regulators) and is a pan-European supervisory authority, the main role of which is to develop binding "technical standards" that give detail to the regulatory architecture set out in the relevant directives.

[4] Article 9a of the Directive requires remuneration policies applicable to significant staff that promote sound and effective risk management and do not encourage inappropriate risk taking. Annex II of the Directive gives more detail on the contents of the remuneration policy. It is not clear how the Directive's provisions on remuneration are going to operate alongside those of the Capital Requirements Directive that come into force on 1 January 2011.

[5] Note that an earlier proposal that the depository had to be an EU credit institution has now been dropped, meaning that a non-EU AIFM may use or continue to use a non-EU depository even if it elects to apply for an EU passport.

requirements, and for many, the degree of regulatory disclosures and scrutiny will represent a real change.

D. How Will a Non-European AIFM Obtain a Passport?

The Directive envisages the authorisation of a non-European AIFM by its "Member State of reference", which looks like it is the Member State with which it has the closest relationship as determined by concentration of marketing activities.[6] If several Member States of reference are possible, the AIFM must submit requests to all of the possible regulators who will then make the determination amongst themselves.

Authorisation is subject to a number of requirements particular to non-EU AIFMs, including: (i) the appointment of a "legal representative" in the Member State of reference; (ii) cooperation arrangements between the Member State of reference and the third country regulator; (iii) the non-EU AIFM's home country cannot be listed as a Non-Cooperative Country and Territory by the Financial Action Task Force ("NCCT"); and (iv) the non-EU AIFM's home country must have entered into an agreement on sharing information on tax matters with the Member State of reference that complies with the OECD Model Tax Convention. The non-EU AIFM must make a written application for authorisation that includes disclosure of its marketing strategy.

At the moment, the mechanics of and pre-conditions for the granting of the passport are set out in very broad terms in the Directive, and it is for ESMA and its technical implementing measures to provide the real detail, and an opportunity to consult on that detail, on how locating the passport's EU state of origin and the contents and criteria for approval are going to be determined. What is clear, though, is that EU legislation and the rules of EU regulators are going to be directly applicable to investment managers established in non-EU jurisdictions and subject (concurrently) to the rules, regulations and law of those non-EU jurisdictions.

E. Non-European AIFM May Continue to Use National Private Placement Regimes

As discussed at paragraph B., above, national private placement regimes are going to continue to be available to non-EU AIFMs until at least 2018. However, the introduction of the Directive does bring with it some additional "harmonised safeguards" that must be put in place in order to ensure compliance with these national private placement regimes. The most significant of these is compliance with the Directive's transparency requirements, *i.e.*, the obligation to publish an annual report, the obligation to make certain disclosures to investors[7] and the

---

[6] Article 35d(4) sets out some very broadly drafted "tests" to be applied in order to determine the Member State of reference.

[7] See Article 20. Disclosures to investors must include a description of valuation procedures and pricing methodology, a description of liquidity risk management, a description of all fees, charges and expenses, an explanation of how the AIFM ensures fair treatment of investors, a description of any preferential treatment and the type of investors who are afforded such preferential treatment and a description of the investment strategy and objectives of the fund.

obligation to make detailed disclosures to regulators. These latter disclosures include information on the main instruments traded and markets used, information on the fund's assets that are illiquid, liquidity management arrangements, risk profile and risk management tools, stress test results and leverage and sources of leverage. In addition, co-operation and tax information sharing agreements must be in place between the Member States into which the funds are to be marketed, the home state of the non–EU AIFM and that of the fund(s) (if different), and neither the AIFM nor the fund(s) may be established in an NCCT. While the latter is a pretty remote consideration for most, the former requirement will require a host of co-operation agreements to be negotiated and put in place by 2013.

Of course, as national private placement regimes are purely a matter for national legislatures, it may be that certain EU Member States, and in particular those that proved most hostile to the idea of granting passports to third country entities, elect to introduce further and more protectionist domestic legislation in order to make the use of national private placement regimes less attractive pending the introduction of the passport.

* * * *

Please feel free to contact any of the following attorneys if you have any questions about this memorandum.

Nick Shiren	+44 (0) 20 7170 8778	nick.shiren@cwt.com
Alix Prentice	+44 (0) 20 7170 8710	alix.prentice@cwt.com
Steven D. Lofchie	+1 (212) 504 6700	steven.lofchie@cwt.com
Assia Damianova	+44 (0) 20 7170 8564	assia.damianova@cwt.com
Marco Crosignani	+44 (0) 20 7170 8678	marco.crosignani@cwt.com
Drew Chapman	+1 (212) 504 6540	drew.chapman@cwt.com
Diana DeBrito	+1 (202) 862 2409	diana.debrito@cwt.com
Gregg Jubin	+1 (202) 862 2485	gregg.jubin@cwt.com
Ed L. Lyon	+1 (202) 862 2249	ed.lyon@cwt.com
Jonathan Wainwright	+1 (212) 504 6122	jonathan.wainwright@cwt.com