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In this issue

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The Changing Regulatory Landscape


by **Peter Astleford** and **Jim Baird**

Over the last two years, there has been an incessant flow of new regulatory initiatives, largely as a response to the recent global financial crisis. The coming of the new year will mark the arrival of some key changes and a phase of ongoing origination, consultation and implementation that is set to continue for years ahead.

On 1 January 2011, Europe will see the European Securities and Markets Authority ("ESMA") replace the Committee of European Securities Regulators ("CESR") as part of a reform of the EU financial supervisory framework. Where CESR acted in an advisory role to the EU Commission, ESMA will assume greater responsibilities and have new rule making powers, including the ability to adopt technical standards that will bind EU national regulators in determining the proper implementation of EU laws. ESMA will also have the selective ability to impose restrictions directly in crisis situations.

While some continuity will be provided by ongoing delegated staff and assistance from national regulators, assuming the extended brief and responsibilities will be an enormous task for an organisation that is still recruiting its staff and establishing its operations. It would therefore not be surprising if the rulemaking process is subject to delays and other teething problems.

One of ESMA's first mandates will be to lead the process for secondary implementing legislation for the proposed EU Alternative Investment Managers Directive (the "AIFM Directive"). This controversial piece of European legislation

(which was approved by the European Parliament last month and is expected to come into effect in the first half of 2013) will introduce a pan-European regulatory regime for managers of alternative funds (and indirectly the funds they manage).

Following its transposition into national law (expected in 2013), almost all funds managed or marketed in Europe will be governed either by the AIFM Directive or the UCITS Directive (the existing European regime for retail funds).

The coming of the new year will mark the arrival of some key changes and a phase of ongoing origination, consultation and implementation that is set to continue for years ahead.

While the AIFM Directive introduces some positive features, such as the passport allowing marketing of funds to professionals across the EU (and the prospect of a similar passport for non-EU funds in five years' time), many believe the AIFM Directive has been an overreaction to the recent crisis and question whether the inevitable regulatory burden and significant associated costs justify the limited investor protection or risk-reduction benefits (see **Depositary Liability Under the EU AIFM Directive** in this Report). Indeed significant provisions in the AIFM Directive (which is focussed on professional investors) go further in seeking investor protection than those currently imposed for the retail sector under the UCITS regime. We can expect that this will result in a "raising of the bar" for the UCITS regime (as is proposed in the recent UCITS consultation) in a new UCITS V Directive.

The AIFM Directive also includes rules on remuneration of risk takers and other highly paid staff that are based closely on similar provisions introduced in the recently amended European Capital Requirements Directive ("CRD III"). These rules include a requirement to defer between 40 and 60 percent of variable remuneration and for 50 percent of variable remuneration to be paid in shares or similar interests. For UK firms, the provisions in CRD III will be reflected in the Financial Services Authority's ("FSA") revised Remuneration Code and will need to be implemented by 1 January 2011. However, as we go to press, the FSA is delaying publication pending its analysis of official guidance published by the Committee of European Banking Supervisors ("CEBS") on 10 December, which will give UK firms only weeks to implement the FSA's code (although some allowance for later implementation will be made). Both the AIFM Directive and CRD III rules contain a proportionality concept that might allow some flexibility, particularly for smaller firms for whom some of these requirements would be difficult to implement. However, even at this late stage, it is not clear how much flexibility will be provided in practice.

In the UK, changes proposed by the coalition government (expected to be in place by 2012) will see the abolition of the FSA and the creation of a new prudential regulator operated by the Bank of England, a new Consumer Protection and Markets Authority and a new agency to tackle serious economic crime. In Ireland, the Financial Regulator has already given way to a resumption of powers by the Central Bank.

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Meanwhile in the United States, work has begun in earnest to implement the comprehensive Dodd-Frank Act adopted in July. The Financial Stability Oversight Council, a new regulatory body with general authority for systemic risk oversight, has begun to meet, and it and various federal financial agencies are seeking public comment on the regulations to be adopted. A general theme in the comments received from the financial industry across several areas is to urge the government to exercise its new powers cautiously and only when there is a clearly identifiable systemic risk that can be remedied by the regulation in question.

From July 2011, the Dodd-Frank Act will eliminate the private fund adviser exemption that many private fund advisers (both U.S. and non-U.S.) rely on and replace it with narrower exemptions for foreign private advisers, "mid-sized" private fund advisers and venture capital fund advisers. The Dodd-Frank Act will, however, require such exempted advisers to submit various reports to the SEC (pursuant to rules that are expected to be adopted prior to July 2011). Mirroring similar provisions in the EU AIFM Directive, the SEC has already proposed certain additional reporting requirements that would be applicable to registered investment advisers as well as mid-sized private fund advisers and venture capital fund advisers that are exempt from registration. These proposed reporting requirements would require information about private funds managed by advisers that are subject to the reporting requirements.

The debate as to whether all these changes are justified by the benefits they may bring will go on.

The Dodd-Frank Act also provides, for the first time, a comprehensive regulatory framework for the U.S. over-the-counter ("OTC") derivatives markets. The provisions include: mandatory clearing and exchange trading for eligible derivatives contracts; new regulatory capital and margin requirements on OTC swap dealers and most large OTC swap participants; and a requirement for swap dealers and major swap participants to register with the SEC and/or CFTC and to continuously disclose detailed information regarding their derivatives trading. In the year ahead, the SEC and CFTC will likely find difficulties in implementing the rules necessary to migrate an unwieldy OTC derivatives market to a cleared and exchange-traded platform.

The U.S. initiative on clearing of derivatives is mirrored by similar proposals for a European Regulation on OTC Derivatives, central counterparties and trade repositories. The European proposals, in addition to centralised clearing of many standardised OTC contracts, would impose additional reporting obligations, common rules for central counterparties and additional measures to reduce credit and operational risk in relation to derivatives trading.

The debate as to whether all these changes are justified by the benefits they may bring will go on. Indeed there is still scope for lobbying for change in the EU's primary or secondary implementing legislative processes. However, the European and G20 political process will ensure, whatever the views of the industry, continued and extensive rewriting of the framework and rules for the global and European financial services business. This will give rise to a prolonged period of transition involving significant change, uncertainty and cost in meeting the increased regulatory burden as well as one-off implementation and, in some cases, restructuring costs. The challenge particularly for the industry in the United States and Europe will be effectively implementing change while minimising the cost and maintaining competitiveness in a global market.

The following articles look at some of the key ongoing changes in more detail. In addition, regular legal updates on a broad range of topics relevant to our clients can be found at http://www.dechert.com/practiceareas/practiceareas.jsp?pg=legal_update&pa_id=19&pn=1.

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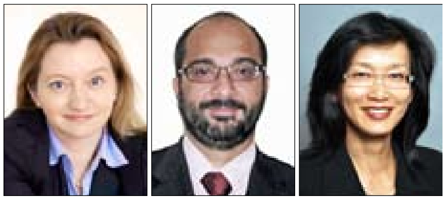
Key Investor Information Document: Friend or Foe?



by **Michelle Moran**, **Antonios Nezeritis** and **Angelyn Lim***

The UCITS IV Directive[1] introduces the key investor information document ("KII"), which reflects the most prescriptive piece of UCITS legislation emanating from the EU. Whilst the idea for the KII was generated some five years ago, the intervening financial crisis has resulted in its aims of delivering transparency and true comparability of UCITS funds resonating with EU and non-EU regulators alike.

Within the EU, national regulators are examining the EU provisions prescribing the distribution of the KII prior to an investor subscribing for shares in a UCITS fund. This article focuses on those EU requirements and comments on the approach being taken by regulators in the principal fund jurisdictions of both Europe and Asia, namely, the UK, Ireland, Luxembourg, Hong Kong and Singapore.

Background

Among the key provisions of the UCITS IV Directive is the replacement of the simplified prospectus ("SP") by the key investor information document. The KII is a short, uniform, pre-contractual document aimed at communicating the essential elements of a UCITS fund to investors, enhancing transparency and allowing direct comparisons to be easily made between UCITS funds and between sub-funds or share classes of the same UCITS fund.

The KII will replace the SP introduced pursuant to the UCITS III Directive. Since its inception, it has become clear that the SP has not fulfilled its intended purpose for various reasons, including:

- National regulatory practices resulted in certain Member States imposing their own rules on the content requirements of the SP, making comparisons between UCITS funds and between sub-funds or share classes of the same UCITS fund difficult.
- Disclosure requirements of the SP resulted in UCITS funds with multiple sub-funds and multiple share classes producing lengthy SPs, defeating the purpose of a simplified document.
- Information in relation to the risks associated with investing in a UCITS fund has not been easily identified in the SP.
- The requirement for a total expense ratio is problematic as the methodology used requires validation by a UCITS fund's auditors that can delay the drafting/updating of the SP.

Features of the KII

The KII seeks to address the shortcomings of the SP by providing a meaningful, user-friendly and comparative document for investors. The UCITS IV Directive and its implementing measures specify the main principles to be followed in preparing the KII, including requirements concerning its language and layout and the main information to be disclosed. To support this,

Language and Layout

The KII should be written in plain language, avoiding technical terms and jargon.

The KII must focus on the key information needed, and likely to be understood, by retail investors.

The language used must be fair, clear and not misleading and must be consistent with the relevant parts of the prospectus.

The KII must not exceed two pages of A4 sized paper when printed (three for structured UCITS funds). It must be easy to read using characters of adequate size. CESR recommends a 10 or 11 point type and sentences no longer than 25 words.

Colour can be used; however, the KII must be comprehensible when printed or photocopied in black and white.

Branding can be used; however, it must not distract the investor or obscure the text.

The KII must be issued in the official language of its host Member State (or a language approved by that Member State's competent authorities).

Cross-references to a website, the prospectus or other sources are permitted; however, the fundamental information necessary for informed investment must be stand alone.

Headers and footers are not permitted.

Single and two column layouts are permitted.

the Committee of European Securities Regulators ("CESR") has undertaken significant industry consultation and has provided guidance on, inter alia, clear language and layout of the KII, the transition from SP to KII, and a KII template.

The KII must be provided to investors "in good time" before their proposed subscription to a UCITS fund. The KII constitutes pre-contractual information for which the management company/self-managed investment company is responsible and liable. The KII should be kept up to date and should be reviewed and revised as appropriate, and in any event, at least once every 12 months (as past performance needs to be updated annually). The KII must be made available no later than 35 business days after 31 December. As a matter of good practice, the KII should be reviewed before the management company/self-managed investment company enters into any initiative that is likely to result in a significant number of new investors. If changes are being made to a UCITS fund's prospectus or its constitutional document, the updated KII must be made available before the change comes into effect.

The KII may be offered to investors in a durable medium other than paper or by means of a website, subject to certain criteria. A paper copy shall be delivered to investors free of charge upon request. The KII must also be available on the website of a UCITS fund or its management company/self-managed investment company.

Types of KII

Multiple sub-funds. Where an umbrella UCITS consists of two or more sub-funds, a separate KII must be produced for each sub-fund.

Multiple share classes. Where a UCITS fund consists of more than one share class, a single share class KII, a multi-share class KII or a representative share class KII may be produced, provided the document does not exceed two pages of A4 sized paper (three for structured UCITS funds). Where a representative share class is used, the class selected must be fair, clear and not misleading to investors in the other share classes. Also, reference to the fact that a representative share class is used should be included in the "Practical Information" section only.

Main Content of the KII

Objectives and Investment Policy

The KII must describe the essential features of a UCITS fund, including the main categories of eligible financial instruments in which it will invest, with reference to any particular geographic, industrial or other market sector targets. Where benchmarks are used, they must be described. This section must disclose whether dividend income is distributed or reinvested and state that investors may redeem on demand, together with an indication of dealing frequency. This replaces the distribution section in the SP. Minimum holding periods, if any, also must be disclosed.

Information to Be Disclosed in the KII

The content of each KII will have a common running order with identical headings. Investors will benefit from this harmonised regime as the information in relation to investment opportunities across the UCITS market will be consistent and comparable.

1. Title "Key Investor Information" followed by an explanatory statement
2. Name of the UCITS fund (including its sub-funds, share classes and investment management company)
3. Objectives and Investment Policy
4. Risk and Reward Profile
5. Charges
6. Past Performance
7. Practical Information
8. Authorisation details of the UCITS fund
9. Date of publication of the KII

There is no flexibility permitted in the order of the content of the KII.

Risk and Reward

The KII must set out the risk and reward profile of a UCITS fund by way of a synthetic indicator presented on a numerical scale, with the UCITS fund assigned to one of the categories of risk. CESR has recommended that the UCITS fund be ranked over a scale of 1 to 7 according to its volatility. The European Securities and Markets Authority ("ESMA") (the body that will replace CESR in 2011) will develop binding technical standards in relation to the methodology to be used to calculate volatility.

The synthetic indicator must be supplemented by a narrative explanation of the indicator and its limitations. Appropriate guidance and warnings must also be set out in relation to the risks that are materially relevant to a UCITS fund and not captured by the synthetic indicator.

Charges

The KII must set out a UCITS fund's charges in a prescribed table, together with a brief narrative explanation. The table outlines the maximum subscription and redemption charges payable by investors as well as a single "ongoing charges" figure representing all charges taken from a UCITS fund over a year and based on the figures for the preceding year. If no charge is applied, the table should indicate "not applicable". Any further charges taken from a UCITS fund under specific conditions (for example, performance fees or switching fees) must also be disclosed. For new UCITS funds, the "ongoing charges" may be estimated. Unlike the SP, there are no requirements to include a total expense ratio and a portfolio turnover rate in the KII.

Past Performance

The KII must contain information about a UCITS fund's performance for the past ten years, presented in a bar chart on a calendar year basis (including the performance of a benchmark, if referred to in the "Objectives and Investment Policy" section). In circumstances where a UCITS fund has a track record of less than five complete calendar years, a bar chart covering only the last five years must be used (the years for which data is unavailable should be left blank). For a UCITS fund with a track record of less than one year, a statement must be included explaining that there is insufficient data to provide a useful past performance indication to investors. Past performance figures must be rounded to one decimal place and the size of the bar chart should not exceed a half page in length.

From SP to KII: Transition

SP can be used up to 30 June 2012 if permitted by the national laws and regulations of the respective Member States.

New UCITS funds authorised after 30 June 2011 must publish a KII.

Existing UCITS funds launching new sub-funds during transition can choose SP or KII.

Existing UCITS funds adding new share classes during transition can choose SP or KII (provided a consistent approach is taken).

Cross-border marketing can use SP or KII (provided a consistent approach is taken).

Strengths of the KII

Plain language: easy to read and understand.

Transparent: has no hidden features.

Uniform: easy to compare UCITS funds and sub funds or share classes of the same UCITS fund.

Facts: contains essential information only.

A simulated past performance may be permitted in certain circumstances, provided it is fair, clear and not misleading. In such cases, there must be a prominent disclosure in the bar chart that the performance has been simulated.

Practical Information

The KII must set out information regarding the UCITS fund's custodian, where and how investors can obtain further information about the UCITS fund and its sub-funds and share classes and where to obtain the latest price information. The KII must also include: information regarding any switching rights between sub-funds; a common declaration of the existence of other share classes with cross reference to the prospectus; disclosure regarding the representative share class, if any; a disclosure that the tax legislation of the UCITS host's Member State may impact investors; and a statement that the management company/self-managed investment company may be held liable for information in the KII that is misleading, inaccurate or inconsistent with the prospectus.

Implementation

Management companies/self-managed investment companies need to prepare for the implementation of the KII as soon as possible. Additional resources may be necessary, although some smaller companies may choose to outsource the KII function. Management companies/self-managed investment companies should ensure the involvement of all key areas of the business so as to complete all of the information necessary for each KII. In addition, significant investment will be needed on an ongoing basis to ensure that each KII produced is current and up to date.

UK, Ireland and Luxembourg

The UCITS IV legislation has yet to be transposed into the national legal systems of Member States and national regulators have yet to publish guidance on how the KII will be implemented. However, it is expected that the EU rules outlined herein will be implemented in the legal systems of the UK, Ireland and Luxembourg in full, with relatively minor national variations relating to timing of transition and accommodation of local marketing practices. This is consistent with the aim of having a standard UCITS funds' pre-subscription disclosure document, thereby moving closer to a single market across all Member States.

Singapore

On 21 October 2010, the Monetary Authority of Singapore ("MAS") issued Guidelines ("Guidelines") on the Product Highlights Sheets ("PHS"). The Guidelines will apply from 1 March 2011 to all funds registered for retail distribution in Singapore, and set out three different PHS templates that serve as the minimum standard—in relation to (i) unlisted debentures in the form of asset-backed securities and structured notes, (ii) exchange-traded funds and notes and (iii) unlisted collective investment schemes.

The PHS must be written in plain language in a "Q&A" format prescribed by the MAS and should describe, among other things: the product's permissible portfolio investments; the profile of customers for which the product is suitable; and the likely risk areas

Challenges

Size: may be difficult to capture all essential elements of a complex UCITS on two pages of A4 paper (three pages for structured UCITS funds).

Plain language: may be difficult to describe sophisticated investment policies adequately using plain language and no technical terms.

Costs: allowances for initial costs and ongoing review/compliance costs will need to be made; however, use of a durable medium or website may help reduce these.

Resources: allowances for additional human and technological resources will need to be made.

Ongoing monitoring and compliance: input from key areas of business will be necessary.

Translation: text can increase by up to 30%. Consideration should be given to using service providers who specialise in financial services translations and providing them with multilingual reference materials, such as glossaries and style guides.

Certainty of transition period: since timing can be determined by each Member State, there is no guarantee that the full transition period will be adhered to.

Distribution infrastructure: consideration should be given to whether existing distribution procedures for the offering of SPs should be mirrored or changed.

that could cause a customer to incur a loss. Issuers should include any additional key information that is necessary for investors to understand the product (and should not merely make reference to information in other sources, such as the prospectus). The PHS cannot contain any information that is not included in the prospectus or any false or misleading information. In the case of a collective investment scheme, where multiple sub-funds are covered in a single prospectus, a separate PHS should be prepared for each sub-fund.

The PHS should not exceed four pages and may include diagrams, corporate logos and a glossary of technical terms, if appropriate. Issuers are encouraged to include links to online copies of disclosure documents, educational resources or explanatory material.

Similar to the KII for European jurisdictions, the PHS must be provided to investors together with the prospectus, before the sale of an investment product. As things currently stand, from July 2011, a KII will be distributed together with a PHS when a registered fund is promoted to retail investors in Singapore.

Hong Kong

In line with global trends emanating from other jurisdictions, and its general enhanced risk disclosure regime, the Hong Kong Securities and Futures Commission (“SFC”) introduced the requirement for a Product Key Facts Statement (“Product KFS”) disclosure document in June of this year.

The Product KFS is intended to be a summary of the key features (and, in particular, the key risks) of the relevant fund, set out in plain language. The SFC’s intention is that the Product KFS of every SFC-authorized fund should look very similar in terms of layout and sub-headings, so as to facilitate reference and comparison by the retail investor. To this end, the SFC has provided, on its website, illustrative templates of the Product KFS for six types of investment products (i.e., guaranteed funds, exchange-traded funds, index funds, investment-linked assurance funds, unlisted structured investment products and general funds). It will shortly be introducing two additional templates—one for synthetic exchange-traded funds and the other for RMB bond funds, both of which have proven, in the recent past, to be very popular retail investment products. For further information regarding the Product KFS requirements, please refer to “Retail Fund Authorization In Hong Kong: The Moving Goalposts,” available at http://www.dechert.com/library/Financial_Services_Report_09-10(asia).pdf.

The SFC has, thus far, adopted an extremely hands-on approach to finalizing/approving the language of, and disclosure in, each Product KFS that has come onto the market. It should be noted that, to date, only equity and bond funds have been authorized with Product KFS. No alternative fund (i.e., hedge fund, exchange-traded fund or managed futures fund) has yet to issue a Product KFS.

Industry groups in Hong Kong had lobbied the SFC to consider an arrangement whereby the KII might be accepted as a fund's summary document in place of a Product KFS. However, given that the SFC has indicated that it does not believe that risk-rating should be reflected in the offering documents of an investment product, it is not surprising that this lobbying movement did not find favour with the SFC, and it may be unlikely to do so in the future. As things currently stand therefore, from July 2011, a UCITS that is authorized in Hong Kong will be required to distribute both a KII and a Product KFS when it is promoted to Hong Kong retail investors.

Communication and Coordination Among National Regulators

Although a number of jurisdictions have been introducing very similar concepts of additional summary disclosure documents, it is not clear whether there has been the appropriate degree of inter-regulator communication and coordination. In particular, funds with cross-border registrations would have more than a passing interest in having streamlined documentation that, ideally, may be used in more than one jurisdiction.

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* *Barbara Cronin, Kristel Gilissen and Sarah Wong also contributed to this article.*

1 EU Directive 2009/65/EC (the "UCITS IV Directive") was adopted by the European Parliament and the European Council on 13 July 2009 and entered into force on 7 December 2009. EU Member States must implement the UCITS IV Directive into their national legislation by 1 July 2011. The UCITS IV Directive replaces the previous Directive 85/611/EEC (the "UCITS III Directive").

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Germany: Ahead of the Game on the KII

by **Angelo Lercara**

There are currently two legislative proposals in Germany that aim to introduce a short, easily readable and understandable document that contains key information for investors in financial instruments: the Key Investor Information Document ("KII") under UCITS IV, and the information leaflet under the draft German Investor Protection Act.

Expedited Implementation of the KII in Germany

The first legislative proposal is based on the so-called UCITS IV Directive, which is more fully discussed in **Key Investor Information Document: Friend or Foe?** in this Report. The UCITS IV provisions will be implemented in amendments to the German Investment Act. The Committee of European Securities Regulators ("CESR") has agreed on the date of 1 July 2012 as the latest date for the implementation of the KII in all Member States.

The draft amendments to the German law would provide for an earlier implementation of the KII than required by the CESR agreement—UCITS set up in Germany would be required to issue a KII to investors from 1 July 2011, instead of 1 July 2012. However, this expedited requirement relates only to German funds (approved by the *Bundesanstalt für Finanzdienstleistungsaufsicht* – BaFin). The draft amendments also contain a grandfathering clause for non-German UCITS admitted to public distribution in Germany prior to July 2011. These UCITS must provide the BaFin with a KII as soon as a KII is required to be produced under the rules of the relevant home state of the UCITS, and in any event by 30 June 2012.

It is unclear whether the grandfathering clause would also be applicable to UCITS currently in existence that are registered for public distribution in Germany after 1 July 2011; the draft amendments do not explicitly address this situation. In our opinion, the grandfathering provision should also be available for such UCITS, since the German Investment Act cannot require supervisory authorities in other EU countries to approve KIIs before the relevant home state rules would impose such an obligation.

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The Information Leaflet Under the Draft German Investor Protection Act

Under a separate legislative initiative, the German Ministry of Finance has published a draft Act to strengthen investor protection and improve capital market efficiency. The German Investor Protection Act would introduce, among other requirements, the obligation for intermediaries deemed to be investment services firms to provide retail clients with a short and easy to understand information leaflet (*Informationsblatt*) before a transaction is concluded and where investment advice is provided. According to the draft, if the financial instruments that are subject of the investment advice are shares of a UCITS, the information leaflet may be replaced (the draft act says "substituted"—("*tritt an die Stelle*") by the KII.

The information leaflet will be introduced by an amendment of section 31 of the German Securities Trading Act (*Wertpapierhandelsgesetz*, the "*WpHG*") that contains the general code of conduct rules for investment services firms.[1]

As discussed above, the obligation to provide the KII would not be imposed until 1 July 2011, at the earliest. Should the Investor Protection Act be enacted before that date, an intermediary that markets German UCITS would need to produce an information leaflet during the period of time between the introduction of the information leaflet and 1 July 2011.

Possible Grandfathering

Currently, the German Ministry of Finance (responsible for drafting both sets of rules discussed above) seems to be of the view that if the information leaflet regime is introduced before 1 July 2011, German UCITS may "ignore" the information leaflet and may continue to use the simplified prospectus until 1 July 2011, when provision of the KII will be mandatory.

The situation is unfortunately unclear for foreign UCITS, and the Ministry of Finance has not yet taken a position on this matter. However, it is likely that foreign UCITS will benefit from the same grandfathering rule and that, until 1 July 2011 such UCITS may use the simplified prospectus instead of the information leaflet.

It is also still unclear whether a foreign UCITS that, according to its home state rules, is not required to produce a KII before 1 July 2012, will be required to produce an information leaflet in Germany from 1 July 2011 or may continue to use its simplified prospectus until 1 July 2012.

Potential Consequences for Foreign UCITS

Distribution Through Exempt Financial Advisors

The Markets in Financial Instruments Directive ("MiFID") includes a provision allowing EU Member States to exempt from the application of MiFID: persons who provide investment services limited to

the receipt and transmission of orders for units in collective investment undertakings; and persons who provide investment advice in relation to such financial instruments and who, in the course of providing such advice, are only allowed to transmit orders to certain licensed entities.

Germany is one of the Member States that has made use of this exemption. The German Banking Act provides an exemption from the license requirement under such Act for “Exempt Financial Advisors”—persons that provide investment broking, contract broking and investment advice in respect of funds (such as foreign UCITS) that are registered for public distribution in Germany, provided such person does not receive or hold monies or shares from or for investors.

An Exempt Financial Advisor is not considered to be an investment services firm and therefore is not subject to the provisions of 31 et seq. *WpHG*. As a consequence, Exempt Financial Advisors will not be subject to the newly introduced requirement to provide retail investors with an information leaflet. However, there has been suggestion that the German government may plan to further regulate Exempt Financial Advisors and that a comparable requirement will be imposed on these advisors to provide an information leaflet in the near future.

Distribution Through Licensed Financial Services Providers

Any other regulated investment services firm will be required to comply with the new rules. As discussed above, the obligation to produce the information leaflet under the *WpHG* will not be directly applicable to the UCITS. It will be an obligation of the investment services firms acting as intermediaries between the UCITS and the clients. However, it may be anticipated that these German distributors will require the domestic and foreign UCITS to produce such an information leaflet in order to continue distribution.

The Information Leaflet

The information leaflet for non-complex financial instruments, such as (currently still) shares of UCITS, may not be longer than two pages of A4 size. It must contain the essential information regarding the financial instrument, set forth in a clear and coherent manner to enable an investor to judge (and make comparisons to other financial instruments) in a best possible way: the type of financial instrument, its functionality, the risks and costs related thereto, and the chances of a repayment of the capital under different market conditions.

The information leaflet may only relate to one financial instrument, and it must not contain any marketing information nor any information that does not relate to the above-mentioned purpose. It may be made available in electronic format.

Outlook

As of the date of this publication, it is not foreseeable how the information leaflet obligations will be applied to foreign UCITS that are not required to make a KII available before 1 July 2012. Information in this respect has not been forthcoming from the BaFin or the Ministry of Finance, and it seems the result will depend on the further legislative procedure and the outcome of the relevant hearings.

In a worst case scenario, foreign UCITS would have two potential options:

- They could produce an information leaflet for the interim period until the KII is available in their home state, which would lead to additional cost and workload uniquely for the German market; or
- They could ensure that a KII is available in the German language by 1 July 2011. However, under this alternative, the UCITS would not benefit from the grandfathering provided for by the UCITS IV Directive and confirmed by CESR.

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[1] The obligation to provide an information leaflet would not apply with respect to professional investors as defined in section 31a para. 2 of the *WpHG*. These generally include, among others: investment services enterprises; authorized or supervised financial institutions; insurance undertakings; collective investment schemes and their management companies; pension funds and their management companies; enterprises whose investment service is solely to provide proprietary business on a German stock exchange or derivatives market; proprietary trading, principal broking services or contract broking on derivatives markets; quotation of prices as market maker on derivatives markets; exchange traders and commodity derivatives dealers; certain other institutional investors; and entities offering the securitization of assets and other financing transactions.

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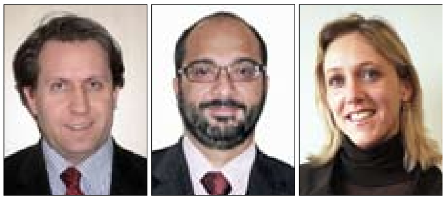
Proposed Changes to the Luxembourg Law on Undertakings for Collective Investment



by **Marc Seimetz**, **Antonios Nezeritis** and **Kristel Gilissen**

EU Directive 2009/65/EC (also often referred to as the "UCITS IV Directive"), which was adopted by the European Parliament and the European Council on 13 July 2009, entered into force on 7 December 2009. Although EU Member States only have to implement the UCITS IV Directive in their national legislations by 1 July 2011, Luxembourg has already taken the lead in the implementation process and deposited a bill with the Luxembourg Parliament on 6 August 2010 in order to implement Level 1 provisions of the UCITS IV Directive into national law (the "Bill"). The aim is to have the Bill adopted before the end of this year with the new law (the "Law") ideally entering into force as of 1 January 2011.

Apart from the implementation of the UCITS IV Directive, the Bill also addresses non-UCITS IV related changes that will have an impact on the Luxembourg investment fund legislation. This article summarizes the non-UCITS IV related changes proposed in the Bill.

Cross-investments Between Sub-funds of the Same Umbrella Structure

The important proposed change to allow cross-sub-fund investments has long been awaited by the Luxembourg fund industry.

The Bill allows cross-sub-fund investments within both corporate and contractual types of funds, subject to several conditions. The investment by one sub-fund into another sub-fund of the same UCITS (or of the same non-UCITS retail fund) ("Target Sub-Fund") is not permitted under the current legislation, due to provisions in Luxembourg corporate law that restrict the acquisition by a company (such as a *Société d'Investissement à Capital Variable* (SICAV) in the form of a *Société Anonyme* (SA)) of its own shares. Although there existed no specific similar rules for contractual type funds (i.e., *Fonds Communs de Placement* (FCP)), the same approach was taken so as not to provide preferential treatment to FCPs.

Although EU Member States only have to implement the UCITS IV Directive in their national legislations by 1 July 2011, Luxembourg has already taken the lead in the implementation process.

The conditions for cross-sub-fund investments are the following:

- For UCITS funds, the standard UCITS investment rules and restrictions apply, which means that:
  - a sub-fund cannot invest more than 20% of its net assets in a Target Sub-Fund;
  - a sub-fund may acquire all the shares of the Target Sub-Fund, provided that those shares do not represent more than 25% of the aggregate number of shares issued by the UCITS as a whole;
  - a sub-fund may invest 100% of its net assets in additional sub-funds as long as the conditions above are complied with; and
  - a sub-fund may not invest in a Target Sub-Fund if the latter is permitted to invest more than 10% of its net assets in UCITS and other undertakings for collective investment.
- Circle investments are not permitted, which means that the Target Sub-Fund may not in turn invest in the sub-fund that is invested in the Target Sub-Fund.
- The double charging of management fees, subscription and redemption fees is prohibited.
- The voting rights that are attached to the acquired Target Sub-Fund's shares are suspended.
- The net asset value of the acquired Target Sub-Fund's shares will not be taken into consideration for the calculation of the net assets of the UCITS

or the non-UCITS for the purposes of verifying the minimum threshold of 1,250,000 €.

- A sub-fund of a UCITS or non-UCITS cannot become a feeder sub-fund of another sub-fund of the same UCITS or non-UCITS.
- Cross-sub-fund investments will be permitted as from the date of the entry into force of the Law, provided that the articles of incorporation of the fund have been duly amended by such date.

Annual Report

The Law will amend the current law to provide that the annual report (including the report of the auditor and the management report) will not need to be sent to the shareholders of a corporate UCITS or non-UCITS retail fund, together with the convening notice for the annual general meeting of shareholders. This cost-saving measure provides that the convening notice shall indicate the place and the practical arrangements for providing these documents to the shareholders and shall specify that each shareholder may request that the annual report be sent to such shareholder.

Record Date for Shareholders' Meetings

The convening notice for a general meeting of shareholders of a corporate UCITS or non-UCITS retail fund may provide that the quorum and the majority shall be determined by reference to the shares issued and outstanding at midnight (Luxembourg time) on the fifth day prior to such meeting (the "Record Date"). The Record Date would be an improvement for large funds with a large number of investors; for such funds, drawing up of the attendance list of the meeting is not always an easy task.

The important proposed change to allow cross-sub-fund investments has long been awaited by the Luxembourg fund industry.

Articles of Incorporation: Language Requirement

For registration purposes, the articles of incorporation of a corporate UCITS or non-UCITS retail fund drawn up in English must be followed by a translation in French or German. Once the Law becomes effective, if the articles of incorporation of such UCITS or non-UCITS retail fund are drawn up in English, it will no longer be necessary to attach a French or German translation.

Tax Change for Sale of Large Participations

If the tax law change set out in general terms in the Law enters into force, tax would no longer be imposed on any revenues that may result from the sale of shareholdings of more than 10% of the net asset value of a sub-fund of a corporate UCITS or non-UCITS fund held for less than six months.

Taxation of Exchange-traded Funds (ETFs)

UCITS or non-UCITS retail funds are generally subject to an annual subscription tax (*taxe d'abonnement*). This tax is 0.05 percent (0.01 percent in certain cases and with possibilities for exemptions), calculated on the basis of the total net assets at the end of each calendar quarter. The Bill provides that Luxembourg ETFs will be exempt from the payment of the subscription tax. As a consequence, Luxembourg ETFs would, in principle, not be subject to any taxes.

Provisions Regarding the Entry into Force of the Law

UCITS or non-UCITS retail funds will remain subject to the current law of 20 December 2002 regarding undertakings for collective investment, as amended, until 1 July 2011 and become subject to the Law only as of 1 July 2011, unless such funds elect to become governed by the Law earlier. It is currently anticipated that the Law will enter into force on 1 January 2011. All the tax provisions of the Law will have effect as of 1 January 2011, with retroactive effect to such date if the Law does not enter into force on 1 January 2011.

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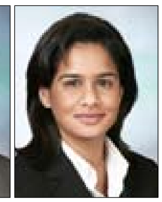
SEC Proposes Rules to Implement Dodd-Frank Investment Adviser Registration and Oversight Provisions Affecting U.S. and Non-U.S. Investment Advisers





by **Julien Bourgeois**, **Mike Sherman** and **Alpa Patel**[*]

The U.S. Securities and Exchange Commission ("SEC") on November 19, 2010 proposed rules under the Investment Advisers Act of 1940 ("Advisers Act") to implement certain provisions of the Private Fund Investment Advisers Registration Act of 2010 ("Advisers Registration Act"), which was enacted as part of the Dodd-Frank Act. The proposed rules, if adopted in their current form, will have far-reaching implications for registered as well as unregistered investment advisers (including discretionary managers), both in the United States and abroad. Most significantly, the SEC proposes to: (i) increase the asset threshold that U.S. advisers generally must meet in order to register with the SEC; (ii) clarify registration requirements for certain smaller U.S. advisers; (iii) define terms and requirements necessary to implement the Advisers Registration Act's exemptions for foreign private advisers, advisers to venture capital funds and "private fund"[1] advisers with less than $150 million in assets under management ("AUM") in the United States; (iv) require all registered and

certain exempt advisers to provide specific information about any private funds they manage; and (v) establish a mandatory, uniform method by which an adviser must calculate its AUM for various purposes under the Advisers Act ("Regulatory AUM").[2]

The proposed rules, if adopted in their current form, will have far-reaching implications for registered as well as unregistered investment advisers, both in the United States and abroad.

Exemptions from Registration Available to Private Fund Advisers and Non-U.S. Advisers

The Advisers Registration Act eliminates the "private adviser exemption" currently set forth in section 203(b)(3) of the Advisers Act, effective July 21, 2011. Currently, section 203(b)(3) exempts from registration any investment adviser that has fewer than 15 clients and does not hold itself out to the public as an investment adviser, provided that the adviser's clients do not include U.S. registered investment companies or business development companies. Historically, private fund managers, as well as many foreign advisers with limited U.S. activities, have relied on this exemption to avoid SEC registration, in part because each private fund managed is considered to be a single "client." With the elimination of this exemption, these advisers will generally be required to register with the SEC, unless another exemption applies.

While the Advisers Registration Act repeals the current section 203(b)(3) exemption, the Advisers Registration Act provides three new, albeit narrower, exemptions that may be available to certain advisers currently relying on the section 203(b)(3) exemption.

Foreign Private Advisers

The first exemption from registration provided by the Advisers Registration Act is an exemption for foreign private advisers ("Foreign Private Adviser Exemption"). The Advisers Registration Act defines a "foreign private adviser" as any investment adviser that, among other requirements: (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the adviser; (iii) has aggregate AUM of less than $25 million attributable to clients in the United States (including U.S.-domiciled private funds) and U.S. investors in private funds advised by the adviser; and (iv) neither holds itself out generally to the public in the United States as an investment adviser, nor advises U.S. registered investment companies or business development companies.

Although the Foreign Private Adviser Exemption is likely to be viewed as the most attractive of the three new exemptions because foreign private advisers are subject to fewer regulatory requirements than advisers relying on the other new exemptions,[3] the Foreign Private Adviser Exemption is quite narrow and likely to be unavailable to most foreign advisers who accept clients or investors in the United States. Each of the strict conditions set forth above must be met in order for an adviser to rely on the exemption (*i.e.*, if an adviser has 15 or more clients/investors in the United States, it cannot rely on the exemption, even if the assets attributable to those clients/investors is below $25 million and, similarly, if an adviser has $25 million or more in assets attributable to clients/investors in the United States, the exemption is unavailable even if all of those assets are attributable to a single client/investor). As a result, a foreign private adviser must carefully and continually monitor and limit both (i) the number of clients and/or investors in the United States and (ii) the amount of assets attributable to such clients and/or investors.

The limit on assets attributable to clients and/or investors in the United States presents particular difficulty as the description of the $25 million limit in the proposed rules would not distinguish between such clients' or investors' initial commitment of capital to the adviser's management and subsequent increases to such capital resulting from an adviser's successful asset management. This may force a foreign private adviser to choose between registering with the SEC and terminating a client relationship or expelling an investor when it appears that the asset threshold is in danger of being breached. It is likely, therefore, that the Foreign Private Adviser Exemption will be of most use not to advisers that seek U.S. business, but instead to advisers who service U.S. persons only as an accommodation.

Venture Capital Fund Advisers

The second exemption provided by the Advisers Registration Act is available to certain advisers to venture capital funds ("Venture Capital Fund Exemption").

The SEC proposes to define a "venture capital fund" as a fund that:

- is a private fund, as defined by the Advisers Registration Act;
- invests in equity securities of "qualifying portfolio companies"[4] in order to provide operating and business expansion capital;
- has acquired at least 80% of its equity investment in each qualifying portfolio company directly from the qualifying portfolio company;
- directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company;
- does not borrow or otherwise incur leverage in excess of 15% of the fund's capital contribution and uncalled committed capital, and any such leverage is for a non-renewable term of no longer than 120 calendar days;
- does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; and
- represents itself as a venture capital fund to investors.[5]

Although the proposed rule implementing the Venture Capital Fund Exemption would not explicitly preclude reliance on the exemption by an adviser whose principal office and place of business is outside of the United States, the availability and utility of this exemption for foreign advisers is unclear. As a result, non-U.S. managers of venture capital funds (as well as U.S. managers of venture capital funds that invest in companies located outside of the United States) may wish to comment on a number of provisions of the proposed rule (as well as possible changes to the proposed rule suggested by the SEC's requests for comments) that may ultimately make reliance on this exemption difficult or impossible for these advisers. First, unlike the Private Fund Adviser Exemption discussed below, the proposed rule as currently drafted would not allow a non-U.S. adviser to rely on the exemption unless all of its clients (wherever located) meet the definition of a venture capital fund. Second, while the proposed rule would allow a venture capital fund to hold *U.S. Treasuries* for cash management or similar short-term purposes, a non-U.S. venture capital fund (which would typically not invest in "U.S. Treasuries") would not be able to invest in similar sovereign debt issued by its home jurisdiction. Third, the SEC's requests for comments include whether the exemption should be limited to funds that are formed under U.S. law and/or that invest only in U.S. companies.

Private Fund Advisers with less than $150 Million AUM in the United States

The third and final exemption provided by the Advisers Registration Act exempts from registration any adviser who acts solely as an adviser to certain private funds, provided such adviser's AUM in the United States is less than $150 million ("Private Fund Adviser Exemption"). Consistent with the current rule for counting clients, which requires U.S. advisers (*i.e.*, advisers with their principal office and place of business in the United States) to count all clients worldwide while allowing non-U.S. advisers to count only their U.S. clients, the SEC's proposed rule implementing the Private Fund Adviser Exemption would allow non-U.S. advisers to disregard any account that is not either (i) managed from within the United States or (ii) an account of a U.S. person that is not a "qualifying private fund,"[6] while requiring a U.S. adviser to consider all of its management activities worldwide. Specifically, under the proposed rule, a U.S. adviser: (i) would not be permitted to advise any client that is not a qualifying private fund; and (ii) could not exceed $150 million in total Regulatory AUM, regardless of where the adviser's qualifying private funds are domiciled or where the management activity occurs. By contrast, a non-U.S. adviser: (i) would satisfy the requirement to advise solely qualifying private funds, provided that no client other than a qualifying private fund is (a) a U.S. person or (b) managed from a place of business in the United States; and (ii) would count only those assets that are managed from a place of business in the United States toward the $150 million limit.

Non-U.S. (as well as U.S.) advisers relying on the Private Fund Adviser Exemption would, as discussed below, be required to file certain information with the SEC and remain subject to limited substantive requirements under the Advisers Act as well as SEC examination authority. In this regard, the SEC's treatment of non-U.S. advisers is not surprising, given the existing "Regulation Lite" approach, under which a non-U.S. adviser to offshore funds has been able to avoid many of the substantive provisions of the Advisers Act, but has been required to register with the SEC as an investment adviser.[7] However, in contrast to Regulation Lite, under the proposed rule a non-U.S. adviser could rely on the Private Fund Adviser Exemption while managing any number of U.S. domiciled qualifying private funds together with any number and kind of

Summary of Implications for Non-U.S. Advisers

- **"Foreign Private Advisers" are exempt from registration, Form ADV reporting and recordkeeping requirements, but are still subject to the anti-fraud provisions of the Advisers Act and certain (but not all) rules thereunder.**
- **As proposed, non-U.S. advisers to venture capital funds that are unable to meet the Foreign Private Adviser Exemption may rely on the Venture Capital Fund Exemption if all of their clients (U.S. and non-U.S.) meet the definition of a venture capital fund; however, such advisers:**
  - **would still be required to report to the SEC on the Proposed Amended Form ADV and would still be subject to certain substantive, anti-fraud and recordkeeping requirements as well as SEC examinations; and**
  - **should carefully review and consider commenting on the proposed rules related to the Venture Capital Fund Exemption.**
- **Non-U.S. advisers to private funds that are unable to meet the Foreign Private Adviser Exemption can rely on the Private Fund Adviser Exemption, and would be required to count only assets managed from a place of business in the United States to determine whether they have Regulatory AUM under $150 million for purposes of the Private Fund Adviser Exemption. Investment advisory activity occurring outside of the United States, even if such advisory activity relates to private funds that are domiciled in the United States or that have U.S. investors, could be excluded for purposes of relying on the Private Fund Adviser Exemption.**
  - **A non-U.S. adviser that manages from the United States, or for a U.S. person, any account that is not a qualifying private fund would not be eligible for the Private Fund Adviser Exemption.**
  - **Even if the Private Fund Adviser Exemption applies, the adviser would still be required to report to the SEC on the Proposed Amended Form ADV and would still be subject to certain substantive, anti-fraud and recordkeeping requirements as well as SEC examinations.**

clients that are not U.S. persons, provided that: (i) without regard to where management activities take place, every client that is a U.S. person is a qualifying private fund; and (ii) with respect to assets managed from within the United States: (a) all such assets are attributable to qualifying private funds and (b) the total value of such assets does not exceed $150 million. As a result, this exemption may be available to non-U.S. advisers who do not service U.S. clients other than private funds, but are unable to meet the more restrictive Foreign Private Adviser Exemption because, for example, the adviser has significant investments by U.S. persons in an offshore fund.

Reporting Requirements for Certain Exempt Advisers

The Advisers Registration Act requires advisers relying on the Venture Capital Fund Exemption or the Private Fund Adviser Exemption ("Exempt Reporting Advisers") to submit, and update at least annually, certain reports to the SEC disclosing organizational and operational information, including:

- basic identifying information;
- other business activities engaged in by the adviser and its affiliates, and information about potential conflicts of interests; and
- the disciplinary history of the adviser and certain of its related persons and personnel.

The information reported by Exempt Reporting Advisers will be used by the SEC to determine whether the activities of an Exempt Reporting Adviser warrant further SEC attention, as these advisers would be subject to examination by the SEC.

In connection with these requirements, the SEC proposes to amend Form ADV ("Proposed Amended Form ADV") to serve as a registration form for registered advisers and a reporting form for Exempt Reporting Advisers. Exempt Reporting Advisers would file the Proposed Amended Form ADV with the SEC through the Investment Adviser Registration Depository system that is currently used by registered advisers. Exempt Reporting Advisers would be required to pay a filing fee and all reports filed on the Proposed Amended Form ADV would be publicly available through the SEC's Investment Adviser Public Disclosure website. Notably, the proposed rules do not require Exempt Reporting Advisers to complete the entire Form ADV and such advisers would not be obligated to prepare, file or deliver to clients the narrative brochure required of registered advisers by Part 2 of the Form ADV. The SEC also proposes amendments to Form ADV applicable to all registered advisers, as well as Exempt Reporting Advisers, that would require specific disclosure regarding, among other things, any private fund advised by the adviser. These reporting requirements would apply to non-U.S. advisers required to file a Proposed Amended Form ADV, but the reporting requirements would only be applicable to private funds organized in the United States or that are offered to, or owned by, U.S. persons.

Exempt Reporting Advisers will also be subject to certain recordkeeping rules as determined by the SEC. The SEC has indicated that it will propose such recordkeeping rules in a separate rulemaking. Most importantly, Exempt Reporting Advisers will also be subject to the anti-fraud provisions of the Advisers Act and certain (but not all) of the rules thereunder and will be subject to examination by the SEC.

Conclusion

The public comment period for the proposed rules ends on January 24, 2011, after which time the SEC will finalize the rules. If the proposed rules are implemented substantially as they are proposed, most advisers can expect to be affected. Advisers that are currently unregistered should begin to consider whether they will be required to register (and if so, whether with the SEC or one or more states) or whether they can rely on an exemption. Advisers that are currently registered with the SEC should determine whether they have sufficient assets (or otherwise will be eligible) to remain registered with the SEC or whether one of the new exemptions would allow them to avoid remaining registered if they so desire. Those advisers who expect to register, or rely on either the Private Fund Adviser Exemption or the Venture Capital Fund Exemption as Exempt Reporting Advisers, should consider what information they will need to compile to complete applicable portions of the Proposed Amended Form ADV and what additional recordkeeping or compliance steps will be necessary given their expected status under the Advisers Act. Advisers should also consider responding to the SEC's requests for comments, in order to influence the final rules and to seek clarification on certain points in the SEC discussion that will accompany the final rules.

For further information regarding the rule proposals, please see December 2010 *DechertOnPoint* "SEC Proposes New Investment Adviser Oversight Rules" at http://www.dechert.com/library/FS_29_12-10_SEC_Proposes_New_InvestmentAdviser.pdf.

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* *The authors would like to thank Sumeera Younis for her assistance in drafting this article.*

1 The Advisers Registration Act defines the term "private fund" as an issuer that would be an investment company for purposes of the Investment Company Act of 1940 (the "Investment Company Act") but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, which captures most investment funds sold through private placements in the United States, including foreign retail funds sold in the United States on a private placement basis.

2 Advisers should focus carefully on the SEC's proposed methodology for determining Regulatory AUM, as an adviser's Regulatory AUM may be the determining factor as to whether, and with which regulator (*i.e.*, the SEC or state regulatory authorities), the adviser is required to be registered. While the proposed methodology is based on the current instructions for calculating AUM for Form ADV reporting and other purposes, changes proposed by the SEC could have the effect of requiring private fund (and other) managers to report significantly higher AUM than under the current methodology.

As proposed, an adviser must include in Regulatory AUM the value of securities portfolios receiving continuous and regular supervisory or management services from the adviser. An adviser would also be required to include in its Regulatory AUM the value of any private fund it manages, even if the private fund was not a securities portfolio (and instead principally invested in commodities, real estate or other non-securities assets), including the value of any uncalled capital commitments to its private funds. Additionally, in contrast to the current calculation of AUM for purposes of Form ADV and various registration thresholds under the Advisers Act, an adviser would no longer be permitted to exclude from Regulatory AUM: (i) proprietary assets; (ii) accounts for which no compensation is paid to the adviser; or (iii) accounts managed for clients that are not U.S. persons.

3 While foreign private advisers are exempt from registration, they would still be subject to the anti-fraud provisions of the Advisers Act and certain (but not all)

rules thereunder. By contrast, as discussed in the text, advisers relying on the Venture Capital Fund Exemption or the Private Fund Adviser Exemption are, in addition to the anti-fraud provisions, subject to public reporting, record-keeping and other requirements (including being subject to the SEC's general examination authority) that are in excess of those imposed upon foreign private advisers.

4 A "qualifying portfolio company" would be defined generally as any company that, among other things: (i) is not publicly traded (nor controls, is controlled by, or is under common control with, a publicly traded company) at the time of investment by the private fund; (ii) does not incur leverage in connection with the investment by the private fund; and (iii) is in the nature of an operating company rather than a pooled fund.

5 Because existing funds may be unable to adjust their terms or portfolio holdings to meet each of these elements of the definition, the proposed rule includes a grandfathering clause that would be available if the fund: (i) was held out to investors as a venture capital fund at offering; (ii) sold securities to at least one investor prior to December 31, 2010; and (iii) does not sell any securities or accept any additional capital commitments after July 21, 2011.

6 A "qualifying private fund" would be defined as any private fund that is not registered under the Investment Company Act and has not elected to be treated as a business development company.

7 *See*, ABA Subcommittee on Private Investment Companies, (pub. avail. Aug. 19, 2006). Although the SEC has not indicated whether it intends to withdraw Regulation Lite or certain related guidance, as a practical matter, if the proposed rule is adopted in its current form, non-U.S. advisers that qualify for the new Private Fund Adviser Exemption should prefer this exemption to Regulation Lite in that, under the proposed rule, a non-U.S. adviser would enjoy slightly more freedom in structuring its management activities by advising domestic private funds while, arguably, being subject to a slightly reduced regulatory burden in that, as discussed in the text, an adviser relying on the new exemption would not be considered to be a registered investment adviser nor required to complete and file Form ADV, Part 2 (a narrative brochure describing business activities, fees and conflicts).

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French Financial and Banking Regulation Law Enacted in Response to the Financial Crisis


by **Olivier Dumas** and **Christophe Garcia**

The French Parliament recently voted to enact legislation that seeks to address many of the perceived causes of the financial crisis and its effects on the financial system. The Financial and Banking Regulation Law (*Loi de Régulation Bancaire et Financière)* of October 22, 2010 (the "Law") contains six main measures: (1) creation of the Council of Financial Regulation and Systemic Risk (*Conseil de Régulation Financière et du Risque Systémique*—the "Council");[1] (2) enhancement of the powers of the Financial Markets Authority (*Autorité des Marchés Financiers*—the "AMF"—French regulator); (3) implementation of a new financial supervisor authority; (4) regulation of derivative instruments and short sales; (5) regulation of credit rating agencies;

and (6) reinforcement of the regulation of providers of financial products and services.

Creation of the Council of Financial Regulation and Systemic Risk

The Council will be a public authority composed of eight members, including representatives of the *Banque de France*, the AMF and the *Autorité des Normes Comptables* (Standards Accountant Authority). The Council's role will be to: ensure cooperation and information exchange between the different financial authorities in France, monitor the financial markets, evaluate systemic risk, facilitate coordination between international and European standards, and express any opinion or position that it may consider relevant. The Council was created to address the causes and effects of the financial crisis and ensure that French measures are consistent with the European and U.S. responses to the financial crisis. The Council will have no power to make decisions, but may advise the French government on decisions.

Enhancing the Powers of the AMF

The Law contains several provisions that enhance the authority of the AMF. The French regulator aims to protect investors and ensure that market information is accurate and the market functions properly. In addition, the AMF is now required to take into account European standards and practices and cooperate with other European regulatory authorities. In the case of exceptional circumstances threatening the stability of the financial system, the president of the AMF will be authorized to restrict the terms of trading of financial instruments for a maximum of 15 days. As a consequence, in the case of a systemic risk, the AMF may impose restrictions on transactions in certain financial instruments. The new regulations also reinforce the AMF's authority to impose penalties. In particular the AMF's General Secretary Assistant (S*ecrétaire General Adjoint)* can determine whether to initiate investigations; a member of the AMF's C*ollege* (internal committee of the AMF, with several powers of decisions) has been authorized to attend the meetings of the *Commission des Sanctions* (AMF's Penalties Committee); penalties have been increased from €10 million to €100 million for corporations and from €1.5 million to €15 million for individuals; and the penalties will now be made public, except if the publicity of the decision may seriously affect financial markets or may cause disproportionate damage to the parties. One of the key provisions of the Law empowers the AMF to apply a settlement procedure in case of non-compliance with the regulations. The parties and the AMF's President also have the right to appeal the decisions of the AMF *Commission des Sanctions* (an independent committee within the AMF, separate from AMF's department in charge of inquiries and prosecutions).

Implementation of a Prudential Supervisor

The Law ratifies the creation in January 2010 of the French entity called *Autorité de Controle Prudentiel* (the "Authority") and makes some changes to its system. The Authority, which resulted from the merger of four regulatory entities in the banking and insurance field, was created in order to preserve the stability of the financial system; protect clients, investors and insured persons; and regulate professionals under its authority. Its main role is to supervise the activities of banking and insurance in France. The major changes effected by the Law relate to the composition of the Authority (an increase from 16 to 19 members), the penalty process (e.g., increase of the penalty amounts, establishment of a *rapporteur* in charge of the investigation procedure, and public disclosure of sanctions) and granting right to the Parliament to conduct inquiries.

Regulating Derivatives Instruments and Short Sales

Derivatives

French law has traditionally punished "market abuses" (e.g., insider transactions, market price manipulation and misinformation) relating to financial instruments traded on regulated markets The new regulation extends the AMF's authority to include financial instruments "related to one or several financial instruments traded on a regulated market." As a consequence, market abuse involving derivatives instruments will be punishable; this provision applies in particular to credit default swaps.

Short Sales

In response to criticisms of short selling practices during the recent financial crisis, a new provision in the French monetary and financial code will prevent a seller from short selling financial instruments traded on a regulated market if the seller does not have for its own account sufficient financial instruments to cover the seller's position or if the seller has not taken necessary measures with a third party to have "reasonable assurance" for the seller's ability to deliver the financial instruments. In addition, delivery times have been reduced.

The reforms should seek to reach a balance between the drive for regulation and the need to ensure Paris' competitiveness as a financial center.

Although this restriction does not apply to financial instruments that are not traded on a regulated market or to buyers, the government and the AMF may, in the future, provide for comparable restrictions to cover such instruments and cover buyers.

Monitoring Credit Rating Agencies

In light of the role played by credit rating agencies in the recent crisis, the Law is designed to increase regulation of such agencies. As a consequence, the AMF will be the competent authority for the registration and supervision of such agencies. In addition, new article L.544-5 of the French monetary and financial code establishes a mechanism of civil liability (*responsabilité délictuelle et quasi-délictuelle*) that applies to credit rating agencies in case of fault or negligent failure resulting in damages for their clients or third parties. Moreover, any clause excluding such liability is prohibited.

Reinforcing the Obligations of Professional Sellers of Financial Services and Products to their Clients

Registration

The Law has consolidated statutes regulating activities of various intermediaries involved in the provision of financial products and services. The Law covers, among others: intermediaries in banking transactions and payment services (*intermédiaires en opération de banque et en services de paiement*), financial investment advisors (*conseillers en investissement;* these are not professionals regulated as investment services providers – *prestataires de services d'investissements, or "PSI"*), and tied agents (*agents lies)*, by listing them as professionals subject to a common requirement to be registered. This list of professionals will be managed by the Agency for the Register of Insurance Intermediaries (*Agence pour le Registre des Intermédiaires en Assurance, or* "ORIAS"). ORIAS is in charge of verifying that theses professionals comply with applicable regulations.

Direct Marketing

Regulation of direct marketing activities (*démarchage*) has been expanded to a cover larger number of financial participants, including intermediaries in banking transactions and payment services and tied agents. In particular, tied agents are now allowed to directly market financial services to the public through any means, including telephone, email and direct contact at the clients' residences. In addition, the Law states that persons can now carry out direct marketing activities on behalf of banking and financial services providers, within the limits of the services, transactions and products for which the principal has been approved. These regulations are designed to increase professionalism and the responsibility of participants in the field of marketing financial services and products.

Conclusion

The Law is just one part of the French government's response to the financial crisis and the systemic risks that contributed to it. It is a first step in regulatory reform of the financial sector that, among other processes, will involve France's implementation of the EU's UCITS IV and AIFM Directives. However, any efforts made by the French authorities to significantly increase the level of regulation should be tempered by the need to avoid excessive constraints for professionals. In addition, the reforms should seek to reach a balance between the drive for regulation and the need to ensure Paris' competitiveness as a financial center.

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[1] Articles L.631-2 et seq. of the French monetary and financial code.

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Depositary Liability Under the EU AIFM Directive

by **Jim Baird**[*]

The European Alternative Investment Fund Managers Directive (the "AIFM Directive" or the "Directive") will, for the first time, impose European-wide regulatory standards on Alternative Investment Fund Managers ("AIFM"). The Directive, which was first proposed in April of last year, has been highly controversial and politically driven. Each of the numerous iterations published since April of last year has stimulated fierce debate over a range of issues, and there has been significant change in the Directive during its passage through the legislative process.

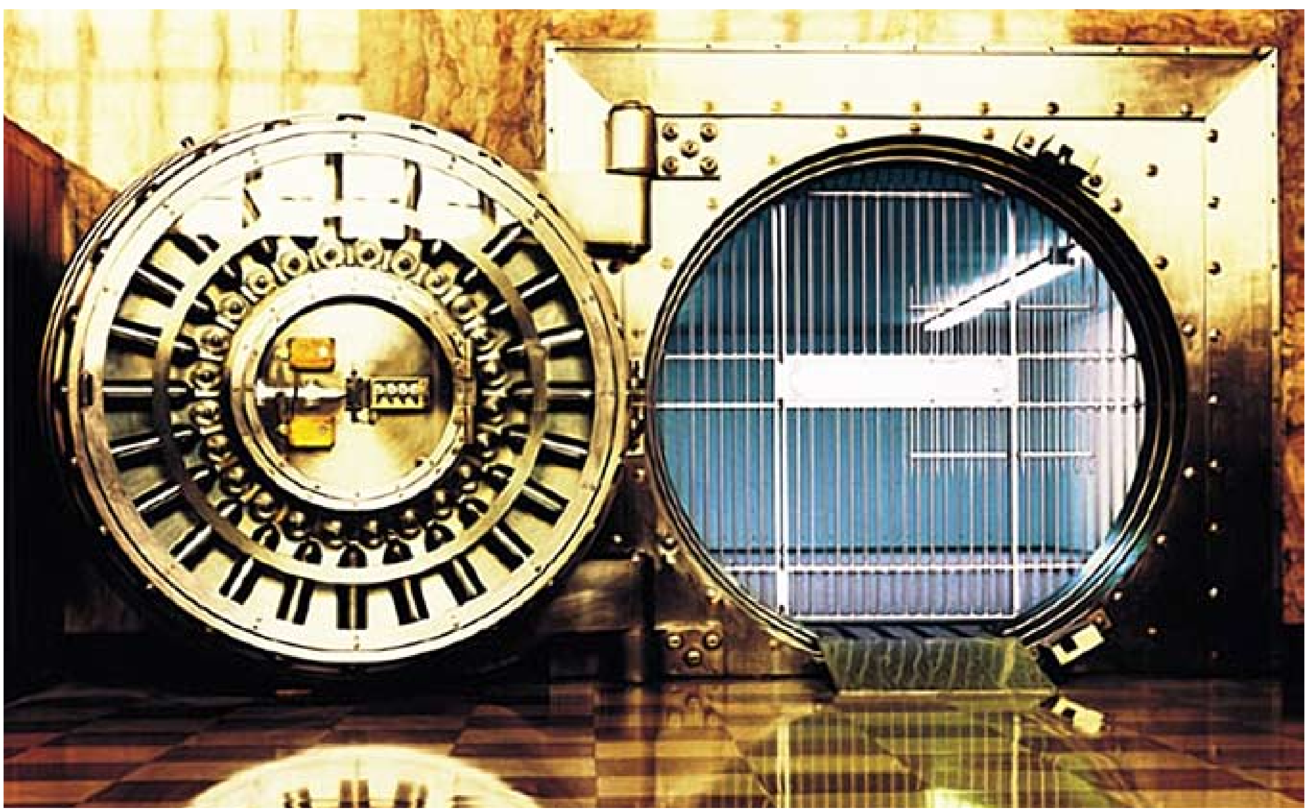
While much attention has focused on the restrictions on management and marketing rights for third country AIFM and Alternative Investment Funds ("AIF"), the provisions relating to depositaries are also of critical importance (and while the impact may not be as immediately visible as the third country restrictions, the cost and other implications are potentially more than just statistically significant).

Requirement for a Depositary

While EU retail funds established under the so-called "UCITS" regime are required to appoint a depositary, until now there has been no equivalent requirement for alternative funds in Europe. The provisions now introduced in Article 21 of the AIFM Directive will require each AIFM authorised under the Directive to ensure that each AIF it manages, has a single depositary.

The provisions specify the categories of entities that may act as depositary. For EU AIF, the depositary must be an EU credit institution, a MiFID investment firm or a UCITS approved depositary. For non-EU AIF, the depositary must be an entity of a similar nature and be subject to effective prudential regulation and supervision of the same effect as that applying to EU credit institutions or MiFID investment firms.

The depositary for an EU AIF must be established in the home Member State of the AIF. For non-EU AIF, the depositary must be established in the jurisdiction where the AIF is established (or alternatively the EU Member State where the AIFM is located or regulated). For non-EU depositaries, there must be cooperation and exchange of information agreements in place between each Member State in which the AIF is to be



marketed and the third country of the depositary. In addition, the depositary's third country may not be blacklisted by the Financial Action Task Force.

Responsibilities of the Depositary

Article 21 dictates certain activities for which the depositary must take responsibility.

The depositary will be required to hold "financial instruments" in custody if they can be registered in a financial instruments account or physically delivered to the depositary. For other assets the depositary must verify and record ownership by the AIF of the asset.

Each of the numerous iterations published since April of last year has stimulated fierce debate over a range of issues, and there has been significant change in the Directive during its passage through the legislative process.

In addition to the traditional depositary functions, the depositary will also be required to carry out certain functions based on parallel requirements for UCITS depositaries. These include: ensuring that the sale, issue and redemption of AIF units comply with the AIF's national law and its constitution; ensuring that the valuation of the AIF units is in accordance with applicable national law and the valuation procedures in Article 19 of the Directive; carrying out the instructions of the AIFM unless they conflict with the applicable national law or the AIF's constitution; ensuring that in transactions involving the AIF's assets any consideration is remitted to the AIF within usual time limits; and ensuring that the AIF's income is applied in accordance with the applicable national law and the AIF's constitutional rules.

There are additional obligations beyond the extended UCITS functions. These include ensuring that the AIF's cash flows are properly monitored, and that subscription and redemption payments and all cash of the AIF have been booked in cash accounts in the name of the AIF with qualifying institutions.

In the context of obligations on the depositary to "ensure" certain matters, there has been suggestion that this will be more in the nature of a supervision requirement than an obligation to procure the specified outcome.

Liability of the Depositary

There are a number of ways in which the liability of a typical AIF custodian acting as a depositary under the Directive will be impacted.

Strict Liability and Reverse Burden of Proof

The Directive imposes liability on the depositary for the loss of assets held in custody (whether held by it or by a sub-custodian) and limits the circumstances when this liability can be discharged. The Directive specifically requires the depositary to replace assets that have been lost with equivalent assets of a corresponding amount.

Under the Directive, the depositary can avoid liability if "*it can prove*" that *"the loss had arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary*". The general concept of liability for depositaries mirrors that in the UCITS Directive. However, the Directive goes further than the UCITS Directive in some important respects (which seems inconsistent given the professional nature of AIFM investors where the justification for investor protection measures is very much reduced).

First, the broad scope of the liability and the limited exclusion mean that liability under the Directive could arise even where the depositary is not negligent or otherwise at fault. Under the UCITS regime, the depositary is not liable unless a loss arises from an "*unjustifiable failure*" on its part. Therefore, the Directive seems to impose more of a strict liability regime than even the retail benchmark set by the UCITS Directive.

Secondly, in order to avoid liability under the Directive, the consequences leading to the loss must have been unavoidable despite "*all reasonable efforts to the contrary*". Thus, the depositary will be liable unless it can show that it exhausted all reasonable steps which might have prevented the loss.

Thirdly, the burden of proof under the Directive now falls on the depositary to demonstrate that it satisfies the requirements in order to avoid liability. The combination of a reverse burden of proof applied in relation to the exhaustive test of having to show that all reasonable measures had been taken, creates an extremely onerous liability regime for depositaries.

In particular, it is not clear how the "*all reasonable efforts*" requirement will be interpreted. Would the depositary be required to have taken all reasonable steps to prevent the loss prior to it arising or would it be sufficient to show that all reasonable steps had been taken once the risk was identified?

Liability for Non-Custody Assets

For losses incurred by the AIF or its investors other than in relation to custody assets, the Directive provides that the depositary is liable where loss is suffered as a result of the depositary's negligent or intentional failure to perform its obligations under the Directive. Thus, for non-custody assets or losses related to the other required functions of the depositary, the extent of liability is closer to the market norm.

Scope of Activities and Standard of Care

In parallel with the express scope of depositary liability outlined above, the Directive imposes what appears to be a sort of standard of care by requiring the depositary (and the AIFM) to act "*honestly, fairly, professionally, independently and in the best interests of the AIF and the investors of the AIF*".

It seems unlikely that this provision would reduce the existing standard of care for negligence in any Member State (where domestic law would continue to apply as normal), although it does seem to have the potential to raise the standard of care required and give rise to claims where none existed before.

In addition, extending the duty of care to both the AIF and its investors may distort the normal position of the depositary acting in the interests of the AIF as its direct client.

Liability for Third Country Depositaries

The Directive permits the appointment of third country depositaries for third country AIF managed under the Directive. In such cases, as the depositaries would not be subject to the laws of an EU Member State, the Directive requires that the depositary must agree to the Directive's liability provisions by contract. Thus, even though not in the EU, a broadly equivalent level of liability will apply as a contractual matter.

Liability on Delegation

The general position under the Directive is that the depositary's liability is not affected by delegation to a sub-custodian. However, the depositary can limit its liability for acts of sub-custodians if it can meet a number of detailed requirements including:

- There must be a written contract between the depositary and the AIF permitting the discharge of liability.
- There must be an "*objective reason*" for the discharge of the liability and the delegate must satisfy and continue to satisfy certain criteria (e.g., expertise, prudential regulation, audit and segregation of assets).
- There must be a written contract between the depositary and the delegate "*explicitly transferring the liability*" and making it possible for the AIF or its investors (or the AIFM on their behalf) to make a claim against the third party in respect of loss of financial instruments.

If all the delegation pre-conditions cannot be met (and where local law requires that assets are custodied locally), sub-custody liability can still be excluded provided this is expressly permitted by the AIF's constitution, certain notice and consent requirements as regards the AIF have been met and the delegate assumes the liability as a matter of contract.

Typically custodians would limit their liability in respect of unaffiliated sub-custodians to losses arising from the custodian's negligence in appointment or supervision of the sub-custodian. Under the Directive, the liability will now be materially increased unless the depositary can pass on liability to the sub-custodian. Local custodians are likely to be reluctant to assume the higher European level of liability or will charge for doing so.

If liability is passed on, it is not clear how the requirement for the AIF or its investors to be able to claim directly against the sub-custodian would be achieved in practice. In addition, the reference to the investors claiming directly against the depositary or through the AIFM creates uncertainty for AIFM as to the nature of any obligation to bring a claim on behalf of investors.

Impact of the Changes

While depositaries have clearly been considering these issues for some time, the redevelopment of their business models is still very much an ongoing process and will undoubtedly be dependent on the detail that emerges from the so-called "Level 2" process (involving the passing of secondary legislation). However, one can speculate as to some of the potential impacts and how this might play out in practice.

Cost

One of the most obvious consequences of the depositary liability provisions is the potential for increase in costs. To the extent that the strict liability for custody of assets continues in its current form, it seems inevitable that there will be some impact on costs (and a portion of these will ultimately be passed on to end investors). The cost impact will, to a significant degree, be a factor of the relative increase in the risk arising from the increase in liability.

For developed markets where well-established sub-custodians are readily available, there may be a greater degree of comfort (and lower cost) than for emerging markets where qualifying sub-custodians may be harder to find. In addition, the impact for the depositary will be dependent on the willingness of sub-custodians to agree to assume liability responsibilities to the AIF (and the costs that they will charge for doing so).

The concentration of risk that would result from this would seem to be contrary to the intended purpose of the Directive (i.e., to reduce systemic risk) and have adverse consequences for the European fund industry.

It seems likely that custody services in higher risk jurisdictions will offer less choice and/or come at a higher cost (where the risk of loss of assets will be greater but the standard of liability under the Directive nonetheless remains unchanged).

Concentration of Risk

Another likely consequence is that large custodians with global custody networks will be better placed to address these difficulties and internalise the sub-custody risk. The result is likely to be that custody of European AIF assets becomes more concentrated among a smaller number of larger custodians who are better placed to manage the liability issues. The concentration of risk that would result from this would seem to be contrary to the intended purpose of the Directive (i.e., to reduce systemic risk) and have adverse consequences for the European fund industry.

Another presumably unintended consequence of the requirement to use qualifying custodians in third country jurisdictions is that exposure of all EU AIF assets in any given jurisdiction may be concentrated in a few custodians, or even a single custodian, able to meet the delegation criteria.

Prime Brokerage

While earlier drafts of the Directive made no reference to the concept of prime brokers, the versions leading up to and including the final version do contemplate prime brokers and the concept of rehypothecation (although the references give only very basic details).

The Directive provides that "*a prime broker acting as counterparty to an AIF is not allowed to act as depositary for this AIF, unless it has functionally and hierarchically separated the performance of its depositary functions from its tasks as prime broker*". The Directive also allows delegation of the custody tasks by a depositary to a prime broker, provided the normal requirements for delegation of custody functions are satisfied.

The Directive also provides that the assets may not be "*re-used*" (or rehypothecated) by the depositary or its delegate without the prior consent of the AIF.

Put together, these provisions would seem to provide scope for arrangements that would facilitate a functional prime brokerage arrangement. However, there will be issues to be addressed depending on which model is adopted.

Provided that the necessary segregation of functions can be achieved, the same entity could fulfil both the depositary and prime broker roles. However, not all entities will have the infrastructure to provide this range of services (particularly given the requirement for the depositary to be in the same Member State as the AIF). Combining the depositary and prime brokerage functions in this way, however, would tend to discourage the use of multiple prime brokers, an approach many funds have increasingly adopted in order to spread their risk.

An alternative model would be to have a separate depositary and one or more prime brokers (either appointed directly or as sub-custodians). However, a third party depositary is unlikely to appoint a prime broker as a sub-custodian unless it is able to divest itself of liability for loss of custody assets by the prime broker (particularly as the prime broker would typically have broad powers to demand re-use of custody assets).

There are issues for the depositary in retaining sufficient control over the custody pool (particularly in light of the strict liability for loss of assets) while also facilitating the constantly changing margin and collateral requirements of the prime brokers or other counterparts. If the increased liability for depositaries results in a need to retain greater control before releasing assets from the custody pool, this could result in more cumbersome and inefficient processes for providing collateral to support the fund's trading requirements.

Another, possibly unintended, consequence of the increased depositary liability is that funds may be incentivised to allow more flexible rehypothecation rights in order to reduce the associated cost. Finally, while the depositary can delegate its custody function, it cannot delegate other functions. Therefore, even where substantive custody functions have been delegated, the depositary would still have to monitor cash flows, redemptions and valuations.

Operational Issues

By virtue of the extension of the responsibilities the depositary is required to assume, potential liability would already have been increased. This is particularly the case given that some of the required activities are functions that historically have been carried out by administrators. It would therefore be necessary to put in place operational and control processes to ensure that these functions can be monitored.

Conclusion

While many were surprised by how far the AIFM Directive's liability provisions have extended (particularly in the way they leapfrogged the less onerous UCITS Directive's retail requirements), it would seem that the UCITS Directive requirements are likely to be conformed to match the AIFM Directive (and not vice versa).

At present, many industry participants are keeping a watching brief. However, increased custody costs seem inevitable, and the question is how significant any increase will be. A degree of concentration seems inevitable and a trend towards larger custodians also likely. The focus for now will be on seeking to ensure these issues are addressed in the Level 2 process.

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* *The author appreciates the input of Dick Frase regarding this article.*

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Upcoming and Recent Events

JANUARY 18, 2011
Time To Pick a Lane: U.S. Regulators Provide a Roadmap for Compliance with Dodd-Frank
London

Since the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted in July 2010, U.S. regulators have been working to develop proposed rules to implement various sections of the Act. This seminar will examine several of the rulemaking proposals that will affect non-U.S. financial services firms, including those related to the investment adviser registration requirements, the swap requirements and the so-called Volcker rule. We will also discuss the investment adviser registration and ongoing compliance requirements generally.

JANUARY 13, 2011
Surviving the FSA Remuneration Code
London

A revised FSA Remuneration Code will come into force 1 January 2011, implementing the remuneration provisions of the Capital Requirements Directive (CRD3). While the revised Code is not yet in final form, it will extend beyond banks, building societies and broker-dealers to cover most of the UK investment management community, including hedge funds and UCITS managers. This seminar will review the impact of the new Code and the likely impact of AIFMD for alternative investment managers as well as the steps that such managers should be taking to ensure compliance and the possible impact of case law on the new rules.

JANUARY 11, 2011
Updating Your U.S. Compliance Calendar for 2011
London

The U.S. federal securities laws impose a variety of reporting and compliance obligations that apply in certain circumstances to UK investment managers and the funds they manage. To assist UK investment managers in planning for 2011, we will review certain of the applicable reporting and compliance obligations, and the impact of Dodd-Frank and other regulatory changes on the timing and content of these obligations.

NOVEMBER 9, 2010
Pay-to-Play: U.S. Advisers Act Rule 206 (4)-5
Webinar

Beginning March 14, 2011, advisers to public pension funds will be subject to the requirements of Rule 206(4)-5 under the Investment Advisers Act of 1940, which limit the ability of the adviser and its employees to make political contributions to certain elected officials. Penalties for violating the Rule will be harsh, including loss of revenues and regulatory sanctions. In this webinar, panelists examined the Rule and its likely impact on public pension fund advisers.

For more information, or to receive materials from the seminars listed above, please contact Beth Goulston at +1 202 261 3457 or beth.goulston@dechert.com.

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