

# Private Equity

The proposed EU Directive on Alternative Investment Fund Managers (AIFM) could have far reaching effects for PE Funds

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Key points to note are:

- The aim of the directive is to establish a comprehensive and effective regulatory and supervisory framework for all EU managed Alternative Investment Funds (AIF), which includes private equity funds, with very limited exemptions.
- The obligations imposed on the AIFM by the draft directive may require significant changes to be made to the AIFM's current business model.
- The private equity industry has objected to being treated homogenously to hedge funds under the draft Directive since the former do not present the same systemic risk.
- The enhanced disclosure regime where an AIF acquires 30% of a body corporate will, as drafted, apply to private equity deals.

### Background

The EU currently regulates under the Directive on the coordination of laws, regulations and administrative provisions relating to undertakings in collective investment in transferable securities (UCITS) the distribution of investment funds to small investors. The draft Directive issued by the Commission on 1 May 2009 seeks to put in place a similar over-arching regulatory and supervisory framework for all EU managed funds not regulated under UCITS to replace what the Commission view as the current fragmented regime.

The directive applies to all AIFM established within the Community irrespective of where the AIF is domiciled.

Further the definition of AIF is drawn very widely and is deliberately not sector specific. As such it will apply to any collective investment undertaking not regulated under the UCITS regime with limited exemptions being:

- An AIFM with assets under management less than €100m, irrespective of the number of AIF managed or the nature of those assets. It is unclear if this is net or gross assets but does include assets "acquired through the use of leverage".
- AIF with assets up to €500m under management which do not use leverage and which prohibit investor redemptions for 5 years from subscription.
- For these purposes a private equity fund comprised of a series of parallel partnerships for different investor classes will be treated as a single pool of assets, if under the management of a single AIF.

Overall few managers are likely to satisfy these requirements and will therefore need to comply with the requirements of the Directive to be able to provide management services to or market any AIF.

Given that the Commission considers that no systemic risks are present and that private equity funds are typically closed ended with a fixed life significantly in excess of five years, the imposition of a highly regulated regime could be viewed as excessive.

In addition the Directive imposes the obligations to comply with the Directive on the AIFM when a number of the functions would typically be exercised by the independent board of the fund. This could both cause:

- Conflicts of interest; and
- Potentially impact on the tax residence of a fund.

These include the appointment of the valuer and the depositary which are dealt with below.

### Timetable – the time to act is now

Time for consultation on the Directive is likely to be very short, so industry participants with significant concerns about the Directive need to act now to get their views heard. The draft will now be sent to the European Parliament and European Council, where the Commission expects it to be the object of intense political discussion and negotiation. If political approval on the Commission's proposals is reached by the end of 2009, the Directive could come into force in 2011.

Given the proposed reach of the Directive, it is crucial fund managers assess the potential impact of the Directive immediately, so that they can seek to influence the shape of the final Directive and its implementing regulations, and, to the extent necessary, start planning for the changes the Directive will require.

### Core requirements of the draft directive

#### Overview

All AIFM which fall within the Directive will need to be regulated by their "home state" financial regulator. The authorisation process will require submission of detailed information to the regulator about managers and controllers, about the AIFs to be managed (strategies and constitution), the countries where the AIFs are to be sold and details of the custodians, valuers and other third parties to whom material functions are delegated.

All AIFM which become regulated will need to have the following:

- Documented internal systems of management and control complying with EU standards (as yet unspecified) relating to liquidity, management of conflicts of interest, risk management (including appropriate "documented and regularly updated due diligence when investing")
- Regulatory capital of not less than €125,000, with additional own funds equal to 0.025% of the amount by which portfolios under management exceed €250m;
- An independent depositary (which must be an EU authorised credit institution), whose function will be to receive investor subscriptions, safe keep financial assets and to verify the AIF has ownership of assets it has invested in.

### Requirement to appoint an independent valuer

An independent "valuator", who must value assets in the AIF, in accordance with local GAAP or in accordance with rules set out in the AIF's constitution. Given the closed ended nature of many private equity funds the requirement will be for an annual independent valuation which many funds already undertake. The requirement to undertake a valuation each time shares or units are issued or redeemed will be of less relevance to this sector.

An AIFM's ability to permit its valuer or depositary to delegate functions to non-EU banks or valuers, to appoint non-EU valuers or custodians or itself to delegate functions (including investment management) to third parties (particularly non-EU entities) will be severely limited and subject to detailed procedural requirements.

### EU auditor

All AIFM will be required to produce an audited annual report for each AIF that it manages, to be made available to investors and its regulators, containing a balance sheet, P&L, and report on activities, and a full audit report. The auditor must be an EU qualified or recognised auditor.

### Disclosure requirements

All AIFM will be required to disclose to their regulators details (yet to be specified) of the principal markets and investments in which they trade (including, on an aggregated basis, details of their principal exposures and concentrations) and details of their leverage through quarterly reporting. The Directive contains unusual provisions specifying that the Commission (rather than a home state regulator) can impose caps on the amount of leverage a AIFM can employ. The home member state of an AIFM can impose additional limits on leverage, in exceptional circumstances if required to maintain financial system stability

### Investor information

#### General

All AIFM will be required to produce detailed investor information for prospective investors and, to the extent they use leverage on a systematic basis, detailed information on that usage on a quarterly basis.

#### Controlling influence in companies

AIFM whose AIFs acquire:

- 30% or more of the voting rights in other bodies corporate; or
- Has an agreement with other AIFM's as a result of which they control 30% or more of a company will be subject to an enhanced disclosure regime.

Whilst there are exemptions for investments in small or medium sized companies the financial limits suggest that this will only provide relief to smaller companies in the PFI sector. More importantly the increasing trend towards forming consortia to acquire large assets means that many private equity transactions will fall within these provisions.

The consequence of this is that funds will need to disclose to shareholders and other stakeholders in the company concerned very detailed information regarding their holdings and plans with regard to their investment as well as information on how they manage conflicts of interest and what their policies for communication are, particularly as regards employees.

For non-listed companies who accept AIF as investors this will mean disclosure of commercially sensitive information which may not currently be publicly available. Private equity funds that acquire and take private a listed company will be required to continue to make disclosures in line with the Transparency Directive as if it were still listed for two years.

Furthermore, supplemental detailed disclosures will be required in the AIF's annual reports on their holdings and plans in relation to them.

### Marketing AIF's

Participations in AIF managed by AIFM which are authorised may be sold only to professional investors (as defined in MiFID). Initially AIF may be marketed to professional investors in the AIFM's home member state but may, subject to complying with passporting requirements be sold to professional investors in other member states.

Although the Directive establishes clear procedures for marketing AIFs domiciled in the EU, the ability of an AIFM to market AIF which are domiciled outside the EU (e.g. in Jersey or Cayman) will be subject to detailed restrictions, including;

- A requirement that the AIF's jurisdiction has signed an agreement to share tax information which complies fully with the OECD standards with the jurisdiction into which the AIF is to be marketed; and
- Granting EU AIFM's effective market access comparable to that granted by the EU to AIFM from that country; a requirement which could be an issue for US Funds.

This passport will not be available for three years, and prior thereto, non-EU domiciled AIF may only be marketed into those EU states where they can currently be sold under domestic law.

## Summary

If the draft Directive is finalised in its current form it will have far reaching implications for the industry in terms of the way in which both fund management business and funds are structured.

As we set out above the current exemptions are unlikely to provide any relief for private equity funds which means that the Directive will need to be complied with.

The reporting and other obligations imposed by the draft Directive will require in many cases:

- Systems changes
- Changes to the business model. For example funds may not have a depositary or an independent valuer
- An acceleration of the audit timetable to produce audited accounts within four months
- Additional regulatory capital

If non-EU domiciles do not sign up to the information sharing framework with the EU, an EU based AIFM will not be able to manage funds domiciled in such countries.

Given the stated intention is to introduce the Directive in 2011 this gives fund managers a relatively short period of time to implement the changes required to their systems and business model.

## Who to contact

If you would like to discuss any of the above issues please do not hesitate to contact your usual PricewaterhouseCoopers contact or one of the specialists listed below:

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