KIRKLAND & ELLIS INTERNATIONAL LLP

KIRKLAND BRIEF

May 2009

EU Alternative Investment Fund Managers Directive Q&A: What is the impact for private equity firms?

The proposed Alternative Investment Fund Managers Directive, if and when enacted, will cover the management of alternative investment funds in or from the EU and the marketing of alternative investment funds to investors within the EU.

On 30 April 2009, the European Commission published a proposed Alternative Investment Fund Managers Directive. If and when enacted, this Directive will regulate alternative investment fund managers operating within the European Union. This Q&A highlights key aspects of the proposals.

As the draft Directive is framework legislation, much of the detail will be contained in implementing legislation to be brought forward by the Commission in due course, and it is not yet possible to assess exactly how the new regime will apply to any given firm.

WHAT DOES THE DIRECTIVE COVER?

The Directive covers:

- the management of alternative investment funds in or from the EU; and
- the marketing of alternative investment funds to investors within the EU.

The Directive covers all investment funds that are not authorised retail funds ("UCITS"), so applies to the managers of real estate funds and infrastructure funds, as well as to private equity and hedge fund managers.

WILL I BE SUBJECT TO THE DIRECTIVE?

If you are a fund manager based within the EU, then yes - unless you qualify as a smaller fund manager (see below) or you do not provide management services to any fund domiciled within the EU and you do not market funds to EU investors.

If you are a non-EU fund manager, the Directive will apply to your marketing activities within the EU. In addition, many nonEU fund managers (whether based in an offshore jurisdiction such as the Channel Islands, or in any other non-EU jurisdiction, including the US) will have an affiliated investment adviser or sub-adviser based within the EU to advise on European investments. That investment adviser will not itself be subject to the Directive. However, based on the preamble to the Directive, it seems that if that investment adviser is regulated under the Markets in Financial Instruments Directive ("MiFID"), it will be permitted to provide investment advisory services only in respect of funds that may be marketed in the EU in accordance with the Directive (see below). This would mean that the non-EU fund manager would need to be subject to domestic regulation equivalent to that imposed by the Directive, and would also need to obtain a marketing authorisation from an EU regulator, for the investment adviser to be able to continue to provide its services.

Banks and other EU-authorised credit institutions, and supra-national institutions such as the EIF, are exempt from the Directive, as are pension funds and life assurance companies.

ARE SMALLER FUND MANAGERS EXEMPT?

Yes. The Directive applies only to fund managers whose aggregate assets under management exceed €100m, although smaller fund managers may opt in.

If the funds are not leveraged, and investors are not able to redeem their investments for at least five years after formation, the threshold is €500m. It is expected that private equity fund managers will generally be subject to

this higher threshold.

The process for calculating the assets under management of a private equity fund manager is not wholly clear, but it appears to be assessed by reference to:

- invested rather than committed capital; and
- current value of investments held (including assets acquired through the use of leverage) rather than acquisition cost.

WHAT IF I AM SUBJECT TO THE DIRECTIVE?

If you are based in the EU, you must be authorised by your national regulator (in the UK, the Financial Services Authority ("FSA")) before:

- providing fund management services; or
- marketing the fund to prospective investors.

For UK-based managers, the authorisation process is likely to be similar to the current FSA authorisation process, but certain additional information will be required. In particular, the limited partnership agreement (or equivalent) for each fund to be managed must be provided to the regulator.

The regulator must grant or refuse authorisation within two months after the application for authorisation is submitted. Once you are regulated in one member state, you may "passport" that authorisation into all other EU countries, subject to certain notification requirements.

WHAT WOULD BEING AUTHORISED MEAN?

Conduct of Business

High level principles

Authorised fund managers will be subject to high level "conduct of business" principles, including an obligation to act with due skill, care and diligence, and in the best interests of investors. These principles will be familiar to firms currently authorised by the FSA.

The principles require that all investors are treated fairly. In particular, no investor may obtain preferential treatment unless this is disclosed in the fund documents. Further, all other investors must be provided with the identity of the preferred investor and a description of the preferential treatment before investing.

Conflicts of interest

Extensive conflict of interest provisions will apply, requiring authorised fund managers to identify and manage conflicts of interest between the fund manager and the investors, and between one investor and another. Firms will be required to put in place adequate arrangements to manage conflicts of interest (for example, Chinese walls). Where conflicts cannot be managed so as to remove any risk of detriment, they must be clearly disclosed to investors.

Risk management

All authorised fund managers must have a risk management function, which must be separate from the investment management function. Consequently, the role of Compliance Officer will need to be a designated role, undertaken by someone who is not an investment executive.

The risk management obligations will require firms, among other things:

- to have a documented due diligence process, which must be regularly updated; and

- to identify, measure and monitor the risks attached to each investment through appropriate stress testing.

Other requirements

There are also additional conduct of business requirements relating to liquidity management and investment in securitisation positions. These will be more relevant to hedge funds than private equity, although technical compliance is likely to be required from all fund managers.

Capital Requirements

Authorised fund managers will be required to hold regulatory capital of the higher of (i) €125,000 plus 0.02% of the amount (if any) by which the aggregate portfolio value exceeds €250m and (ii) one quarter of fixed annual overheads.

This is intended to enable investors to claim damages in the event of fraud or wrongdoing by the fund manager.

Organisational Requirements

Valuation

The fund manager must appoint an independent "valuator" for each fund, whose role is to establish the value of both portfolio company investments held by the fund and interests in the fund itself.

The valuator must ensure that the assets of, and interests in, each fund are valued at least once a year, and each time interests in the fund are issued or redeemed, if this is more frequent.

Custody

The fund manager must also appoint a depositary to:

- eceive all amounts drawn down and book them in a segregated account;
- safe-keep any financial instruments belonging to the fund; and
- verify whether the fund has obtained ownership of all assets other than financial instruments.

The depositary must be an EU-regulated credit institution, and will be directly liable to investors for any loss suffered as a result of its failure to perform its obligations.

Transparency

Annual report

Each authorised fund manager must make an annual report available to investors and to the regulator, which must include audited financials and a narrative report plus, where relevant, certain portfolio company information (see below).

Disclosure to investors

Authorised fund managers must provide certain information to investors before they invest and in the event of any subsequent changes. This includes, among other things:

- a description of the fund's valuation procedures, including the methods used in valuing hard-to-value assets; and
- a description of all fees, charges and expenses, and the maximum amount of fees which are directly or indirectly borne by investors.

Reporting to the regulator

An authorised fund manager must regularly report detailed information to the regulator. The information to be provided is more relevant to hedge funds than to private equity funds, but includes:

- the risk profile of the fund and the risk management tools employed by the fund manager to manage those risks;
- the main categories of assets in which the fund is invested; and
- a list of funds managed, on a quarterly basis.

The detail of these provisions is not yet available, and it is not yet clear exactly how these reporting requirements will be applied to private equity funds.

Leverage

The Directive includes additional obligations in relation to funds "employing high levels of leverage On a systematic basis." It is thought that these provisions are aimed at hedge funds, and are intended to cover only leverage applied at the fund level.

Where a fund systematically employs leverage, the fund manager must make additional disclosures to both investors and the regulator, and there will be limits on the amount of permitted leverage.

Portfolio Company Information

Where a fund (individually or aggregated across all funds managed by the same manager) acquires 30% or more of a company, notification and disclosure requirements apply, unless the company is a non-listed SME.

Information on acquisition

If the company is unlisted, the fund manager must notify the company and all other shareholders of the acquisition of a 30% shareholding. In relation to listed companies, the acquisition of a 30% stake would trigger a mandatory takeover bid in many EU jurisdictions but, even if the mandatory bid threshold is higher (for example, the threshold in several countries is ‘A), the fund manager must provide the company, the other shareholders and representatives of employees with the information that would be required to be included in a takeover offer document.

In addition, the fund manager must disclose to the company itself, to all other shareholders and to employee representatives:

- for non-listed companies, the development plan for the company;
- the policy for preventing and managing conflicts of interest, in particular conflicts between the fund manager and the company; and
- the policy for external and internal communication of the company, in particular as regards employees.

Annual reporting

Where a fund exercises a controlling influence over a portfolio company, the fund manager's annual report must include, for each portfolio company:

- details of the capital structure;
- details of the composition and operation of the board, or equivalent management arrangements;
- information with regard to operational and financial developments: presentation of revenue and earnings by business segment; statement on the progress of the company's activities and financial affairs; assessment of expected progress on activities and financial affairs; report on significant events in the financial year;
- information with regard to financial and other risks: at least financial risks associated with capital structure;
- information with regard to employee matters: turnover, terminations, recruitment; and

- a statement on significant divestment of assets.

The above information must also be provided directly to employee representatives.

WHAT ABOUT MARKETING TO EU INVESTORS?

EU-Based Managers

EU-domiciled funds

If you are an authorised fund manager, you may market fund interests to professional investors across the EU. For these purposes, the definition of "professional investor" will include all institutional investors, but is likely to exclude most, if not all, high net worth individuals. It will still be possible to market fund interests to retail investors (including high net worth individuals) where this is permitted by national law, although it looks likely that additional regulatory requirements would be imposed on any such marketing.

Before marketing commences, the fund manager must provide its regulator with, among other things:

- details of the fund; and
- the fund documents (expected to include the limited partnership agreement and information memorandum).

The regulator will then have 10 working days to inform the fund manager whether marketing may commence, and the regulator may impose restrictions or conditions on marketing. Once permission has been granted, the fund manager may begin marketing in its own member state.

Where the fund will also be marketed in other EU jurisdictions, the fund manager must notify its regulator of the other countries in which the fund is to be marketed, and the regulator must then send the required information to the national regulators in each of the relevant countries before marketing can be undertaken.

Non-EU domiciled funds

In relation to non-EU domiciled funds, the above rules apply, with one additional requirement: an authorised fund manager may market interests in a non-EU domiciled fund only if the fund's jurisdiction of domicile has signed an agreement with the relevant member state which fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention (that is, it provides for bilateral exchange of information for tax purposes).

Non-EU Fund Managers

Fund managers based outside the EU (whether in an offshore jurisdiction such as the Channel Islands, or any other non-EU jurisdiction such as the US) may be authorised to market fund interests to professional investors across the EU in the same manner as an EU-based fund manager. It currently appears that a non-EU fund manager may select the EU member state in which it wishes to be authorised.

Authorisation may be granted to a fund manager based in a non-EU jurisdiction only if:

- the European Commission has determined that the legislation in the non-EU jurisdiction regarding prudential regulation and on-going supervision is equivalent to the provisions of the Directive, and is effectively enforced;
- the European Commission has determined that the non-EU jurisdiction grants comparable market access for EUbased fund managers;
- the fund manager provides the relevant EU regulator with the same information as would be required to be provided by a domestic fund manager seeking both authorisation and permission to market fund interests;
- there is a cooperation agreement in place between the relevant regulator and the fund manager's own super-

visor which allows an efficient exchange of all information that is relevant to systemic risk; and

- the non-EU jurisdiction has signed an agreement with the member state in which authorisation is sought which fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention.

Is It Law?

Not yet. The draft Directive must now be debated and agreed by both the European Parliament and the Council (in effect, the governments of each EU member state), both of which can make changes to the draft or even block the legislation entirely (although this is unlikely).

The proposals are politically controversial, and it is possible that they may change significantly during the next few months. Industry associations, such as the British Private Equity and Venture Capital Association ("BVCR') and the European Private Equity and Venture Capital Association ("EVCA"), are currently highlighting those aspects of the proposals that would cause material damage to the private equity industry, and would consequently limit the industry's ability to provide companies with much needed capital in the current financial climate. Conversely, certain members of the European Parliament are calling for even more stringent regulation, asserting that the current proposals contain too many loopholes to be effective.

WHEN WILL THE PROPOSALS TAKE EFFECT?

The process of reaching agreement on the exact terms of the legislation typically takes around 15 months, although the Commission is suggesting that the process could be complete by the end of 2009.

Once political agreement has been reached, it is expected that member states will have 18 months to implement the Directive into national law, so the Directive could come into force during 2011.

However, there will be a further transitional period of three years for the provisions relating to the marketing of non-EU funds and the authorisation of non-EU fund managers. In the meantime, member states may continue to allow fund managers to market non-EU funds in accordance with national law (although EU-based fund managers would still need to be authorised under the Directive in relation to their fund management activities).

Should you have any questions about the matters addressed in this *Kirkland Brief*, please contact the following Kirkland authors or your regular Kirkland contact.

Lisa Cawley
http://www.kirkland.com/lcawley
+44 20 7469 2140

Stephanie Biggs
http://www.kirkland.com/sbiggs
+44 20 7469 2235

Kirkland & Ellis International LLP
30 St Mary Axe
London, EC3A 8AF
United Kingdom

Kirkland & Ellis International LLP is a limited liability partnership established in Delaware, and the liability of its partners is limited in accordance with section 15-306(c) of the Delaware Revised Uniform Partnership Act.

This publication is distributed with the understanding that the author, publisher and distributor of this publication are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to applicable rules of professional conduct, this publication may constitute Attorney Advertising.

©2009 KIRKLAND & ELLIS INTERNATIONAL LLP. All rights reserved.

www.kirkland.com