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KIRKLAND **BRIEF**

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EU Alternative Investment Fund Managers Directive: Swedish Presidency Issues Compromise Proposal

The suggested changes to the EU Alternative Investment Fund Managers Directive, although only discussion points at this stage, seem to be broadly favourable to the private equity industry.

Since the European Parliament reconvened after the summer break, there has been much debate over the proposed EU Alternative Investment Fund Managers Directive, and it now seems clear that the Directive will be substantially revised before a final version is put to a vote.

The Directive will become law only if it is agreed by the directly elected European Parliament and the Council of the European Union, which comprises the governments of each Member State. In a significant development, on 12 November, the Swedish Presidency of the Council published a new compromise text proposing amendments to the draft Directive published earlier this year.

The suggested changes (which are only discussion points at this stage) would seem to be broadly favourable to the private equity industry, although the proposed inclusion of provisions on remuneration is likely to prove controversial.

Scope of the Directive

The revised text sets out more clearly the intended scope of the Directive, defining precisely the activities and entities that would be covered. Under the compromise proposal, the requirement for authorisation would apply to those firms that manage alternative investment funds. Fund management would comprise certain specified activities including portfolio management, risk management and compliance, and fund administration and marketing, and the authorised fund manager would have ultimate responsibility for these activities even though certain functions might be delegated or outsourced.

For the moment, the AUM trigger thresholds remain the same (€100m, or €500m for closed-ended funds that do not use leverage as part of their investment strategy), although they are under discussion.

Management of Non-EU Funds

EU-based fund managers would be permitted to manage funds established in non-EU countries if legislation in the non-EU country is in line with the standards set by international organisations such as IOSCO, and a cooperation agreement is in place between the relevant regulators. There would no longer be a three-year transitional period before these rules came into effect.

However, the pan-European private placement regime for professional investors would be available only where the fund itself is established in the EU (and, if the fund is a feeder fund, where the master fund is also established in the EU). Non-EU funds would have to be marketed under national private placement regimes, as at present.

Non-EU Fund Managers

The compromise proposal would reduce the territorial scope of the Directive so that non-EU fund managers would not be required, or eligible, to seek authorisation under the Directive, even for marketing purposes. Non-EU fund managers would not, therefore, be able to take advantage of the new pan-European placement regime. This would not be a major concern if national private placement regimes continued to be available, but it is still not wholly clear that non-EU fund managers will be able to market to EU investors at all.

More encouragingly, the revised text does not seek to take forward the requirement that firms authorised under the Markets in Financial Instruments Directive (which would include many private equity sub-advisers to offshore and U.S. funds) should be able to provide services only in respect of funds whose managers are authorised under the Directive. Consequently, under these proposals it would be possible for existing sub-advisory arrangements to continue.

Remuneration

Controversially, the proposals include new provisions that would both regulate and require disclosure of the remuneration paid to fund executives. Fund managers would be required to have remuneration policies for key personnel, and larger firms would be required to appoint a remuneration committee. Variable remuneration, including both bonuses and carried interest, would be subject to a requirement that 40 percent (or 60 percent if the amount is "particularly high") is deferred over at least a three-year period. The total remuneration and carried interest paid would have to be disclosed in the firm's annual report, and where executives are paid more than the average paid to a director on the firm's board, these amounts would have to be disclosed individually (on an anonymous basis).

Regulatory Capital

The proposals appear to recognise that a requirement to hold large amounts of "regulatory capital" is not appropriate for managers of private equity funds. Consequently, it is suggested that managers of funds:

- make investments and divestments solely on an infrequent basis;
- do not employ leverage as part of their investment strategy;
- do not have redemption rights exercisable within five years from establishment; and
- should have a fixed regulatory capital requirement of €50/€60,000 (broadly the same as the €50,000 "exempt-CAD" regulatory capital requirement that already applies to a number of private equity firms).

For hedge funds, it is proposed that the regulatory capital requirement should be capped at a maximum of €10,000,000, and it would be possible for half of this amount to be provided by means of a bank guarantee.

Portfolio Company Disclosure

The proposed amendments include some useful improvements to the "Walker-style" transparency and disclosure requirements. Listed portfolio companies would be taken wholly outside the regime, with disclosure instead being governed solely by the existing Takeovers Directive and Transparency Directive. For unlisted portfolio companies, the disclosure requirements would only apply to majority-owned investments (excluding SMEs), instead of being triggered on the acquisition of a 30 percent stake, and it would no longer be obligatory to disclose the company's business plan.

Leverage

The compromise proposals clarify that limits on leverage should be imposed only where the stability and integrity of the financial system is threatened. For private equity firms, the revised text includes a useful clarification that "leverage" means leverage used as part of investment strategy, which would reduce concerns that equity bridge facilities might bring otherwise un-leveraged funds within the disclosure and reporting requirements for leveraged funds.

Valuations

If adopted, the revised valuation requirements would be a significant improvement on the original proposals. Whereas the original draft of the Directive requires all investments to be valued by an independent valuator, the compromise proposals would instead require firms to implement proper valuation procedures using appropriate valuation models. However, individual Member States would be permitted to require either the valuation procedures or the valuations themselves to be independently audited.

Depositary

For private equity firms, this is one aspect of the proposed Directive that would continue to cause difficulties. The compromise proposals would still require all funds to appoint a separate depositary, who would have responsibility for custody of investments, verification of title to assets, and ensure that investor subscriptions and fund valuations are carried out in accordance with the fund agreement. These requirements still do not sit comfortably with the private equity model. In addition, it is still proposed that the depositary should be directly liable to investors for losses resulting from custody failures, which could substantially increase fees.

Timeline

The compromise proposals suggest an implementation period of 24 months. If this were to be adopted, it is unlikely that the Directive would now come into force across the EU before mid-2012.

What Happens Next?

The Presidency's compromise text is only a discussion document, and it is not yet possible to tell whether all or any of the proposals will be adopted. The European Parliament has yet to put forward its own proposed amendments, which may be less favourable to the industry, and it will be some time before a final compromise is reached. However, the proposed changes do suggest that the industry is beginning to get its message across — at least in some areas.

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