

KIRKLAND BRIEF

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Regulation of European Private Equity Firms: Where are we now?

Recent developments to the EU Alternative Investment Fund Managers Directive and the U.S. Private Fund Investment Advisers Registration Bill will affect European private equity fund managers.

In the last two weeks, there have been further developments for European private equity fund managers in relation to both the EU Alternative Investment Fund Managers Directive and the U.S. Private Fund Investment Advisers Registration Bill. As legislators and regulators pause for the Christmas break, this briefing note summarises the current state of play.

EU Alternative Investment Fund Managers Directive

The EU has a twin track legislative process. Both the directly elected European Parliament and the Council (which comprises the governments of each Member State) are reviewing and amending the proposed Directive, using an essentially iterative process to reach an agreed version.

The most recent compromise proposal was published by the Swedish Presidency of the Council on 15 December 2009, together with a progress report. The progress report indicates that the Member States are largely agreed, save for four key issues:

- **Depository:** Whether firms that are not either EU credit institutions (that is, banks) or investment firms authorised under the Markets in Financial Instruments Directive (MiFID) should be permitted to act as depositaries for alternative investment funds.
- **Valuation:** How to adjust valuation requirements to suit different business models, and how to ensure independence.
- **Remuneration:** Whether the detailed rules now applicable to banks should be applied equally to alternative investment fund managers (AIFM), or whether the rules should be adapted, especially regarding carried interest.
- **Third Country Issues:** How to ensure a level playing field between EU and non-EU funds marketed in the EU; specifically whether non-EU funds managed by EU managers should be exempted from the depository requirements.

From 1 January 2010, Spain will take over the Presidency and should continue working on these outstanding issues to reach agreement within the Council. However, Spain is generally viewed as less industry-friendly than Sweden, so it is possible that other points may be revisited.

The latest official document produced by the European Parliament is the draft report of Jean-Paul Gauzès, the Rapporteur (the MEP with responsibility for taking the proposal through the Parliament). This was published on 23 November 2009, although there have been subsequent informal discussions with the Council. MEPs have until 21 January 2010 to table amendments to the report, which should be debated in committee on 22 February 2010 and put to a full vote of the Parliament in early July.

It is probable that the final version of the Directive will reflect elements of both the latest Swedish compromise proposal and the Gauzès report. The table set out at Appendix 1 shows how each of these compares to the original proposal on certain key issues.

U.S. Private Fund Investment Advisers Registration Bill

On 11 December 2009, the House of Representatives approved an omnibus financial services bill, which includes the Private Fund Investment Advisers Registration Act of 2009. A “companion bill” must be passed by the Senate before the Act becomes law, so the details are not yet final, but it is anticipated that the companion bill will be taken up by the Senate in the first half of 2010.

Under the bill passed by the House, private equity firms with a place of business in the U.S. and non-U.S. firms with significant commitments from U.S. investors will be required to register with the SEC from 2011. Firms without a U.S. office are likely to be required to register if they manage \$25 million or more of commitments from U.S. investors and have AUM of \$150 million or more in total.

Under the proposed registration regime, private fund managers would not only have to register with the SEC and become subject to its supervision, but would also be required to file confidential reports designed to allow regulators to monitor systemic risk. If private funds are found to pose systemic risk, they could be subject to additional restrictions.

Our global regulatory team will be holding a breakfast seminar in February to explain how EU-based fund managers are likely to be affected by the new U.S. legislation, and what SEC registration entails. Invitations will be sent early in the new year.

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Appendix 1
AIFM Directive Comparison Table

	Original Proposal	Swedish Presidency Compromise Proposal (Council)	Draft Gauzès Report (European Parliament)
Scope	<ul style="list-style-type: none"> • Applies to all AIFM established in the EU • An AIF is any fund that is not a UCITS • Exemption for managers with <€100m AUM, or <€500m if funds are not leveraged and there are no redemption rights within five years 	<ul style="list-style-type: none"> • Extended to cover “internally managed” AIF such as investment trusts • Group exemption added • AIFM below the threshold must be regulated at national level 	<ul style="list-style-type: none"> • No AUM thresholds - all AIFM are covered. Instead, requirements are to be applied in a “proportionate” way
Authorisation	<ul style="list-style-type: none"> • Must be authorised to: <ul style="list-style-type: none"> ○ provide management services to an AIF ○ market an AIF to EU investors 	<ul style="list-style-type: none"> • AIFM may carry on no other business, except managing UCITS (if authorised to do so) and, where individual Member States permit, discretionary portfolio management for individual clients 	
Capital Requirements	<ul style="list-style-type: none"> • Own funds of €125k • Plus 0.02% of AUM >€250m • Or, if greater, the amount required by the CAD (usually 1/4 annual overheads) 	<ul style="list-style-type: none"> • Reduced capital requirements (€50k) for AIFM who are below the AUM threshold but have opted to be authorised under the AIFMD • Own funds requirement capped at €10m as for UCITS management companies • 50% of own funds may be provided by way of bank guarantee 	<ul style="list-style-type: none"> • Own funds requirement capped at €10m as for UCITS management companies • 50% of own funds may be provided by way of bank guarantee

	Original Proposal	Swedish Presidency Compromise Proposal (Council)	Draft Gauzès Report (European Parliament)
Conduct of Business			
<ul style="list-style-type: none"> • Remuneration 	-	<ul style="list-style-type: none"> • Remuneration policy required for senior management, risk takers and control functions as for banks. • At least 40% of variable remuneration to be deferred over at least three years, or 60% if a “particularly high amount,” and deferred amounts to be paid only if sustainable and justified. This includes carried interest but not returns from co-investment. 	<ul style="list-style-type: none"> • G20 principles on remuneration for staff in banks should apply to AIFM
<ul style="list-style-type: none"> • Conflicts of Interest 	<ul style="list-style-type: none"> • Must identify and manage conflicts to prevent detriment to investors 	<ul style="list-style-type: none"> • Essentially no changes 	<ul style="list-style-type: none"> • Essentially no changes
<ul style="list-style-type: none"> • Risk Management 	<ul style="list-style-type: none"> • Must have a separate risk management function • Must ensure risk profile of fund is appropriate and reflects fund documents • Prohibition on naked shorting 	<ul style="list-style-type: none"> • Requirement for separation of functions to be proportionate to scale and complexity of AIFM • Prohibition on naked shorting removed 	<ul style="list-style-type: none"> • Must disclose significant short positions to regulator • New EU regulator may impose restrictions on shorting in exceptional circumstances to ensure financial stability
<ul style="list-style-type: none"> • Liquidity Management 	<ul style="list-style-type: none"> • Must have a liquidity management system to ensure liquidity profile matches redemption obligations 	<ul style="list-style-type: none"> • Not to apply to unleveraged, closed-ended AIF 	<ul style="list-style-type: none"> • Essentially no changes

	Original Proposal	Swedish Presidency Compromise Proposal (Council)	Draft Gauzès Report (European Parliament)
Organisational Requirements			
<ul style="list-style-type: none"> • Valuation 	<ul style="list-style-type: none"> • Must appoint an independent valuator • Valuations to be carried out annually and at each closing • Valuation rules to be laid down by Member States 	<ul style="list-style-type: none"> • No requirement for an independent valuator, although valuation must be a separate function in larger firms • Must have appropriate and consistent valuation procedures 	<ul style="list-style-type: none"> • AIFM and depositary are jointly responsible for proper valuation of assets • Must appoint a valuator, who must be an EU-regulated firm • Independence must be embedded in valuation process, although valuator need not be independent of AIFM • Requirement to appoint a valuator does not apply to private equity funds
<ul style="list-style-type: none"> • Delegation 	<ul style="list-style-type: none"> • AIFM can delegate only with approval from regulator • Delegation of portfolio management to other AIFM only 	<ul style="list-style-type: none"> • Prior notification requirement not pre-approval requirement • Delegation of portfolio management to regulated entities only (not just other AIFM), unless regulator agrees otherwise • AIFM must retain substance and remains fully liable to investors despite any delegation 	<ul style="list-style-type: none"> • Prior notification requirement not pre-approval requirement, but regulator may “reject” delegation • Delegation of portfolio management, risk management or liquidity management to other AIFM authorised to manage the same type of fund only • AIFM must retain substance and remains fully liable to investors despite any delegation • Investors must be notified of delegation

	Original Proposal	Swedish Presidency Compromise Proposal (Council)	Draft Gauzès Report (European Parliament)
<ul style="list-style-type: none"> • Depository 	<ul style="list-style-type: none"> • Must have an independent depository to: <ul style="list-style-type: none"> ○ Receive drawdowns and keep fund money in a segregated account ○ Safe-keep financial instruments ○ Verify title to assets • Depository must be an EU credit institution (bank) • Depository is liable to investors for losses 	<ul style="list-style-type: none"> • Still under discussion • Permissible depositaries to include MiFID firms and possibly other entities regulated at national level • Non-EU firms cannot be depositaries, but main depository may delegate to a sub-custodian where there is an objective reason for doing so, provided it is regulated in the relevant jurisdiction 	<ul style="list-style-type: none"> • Depository to have additional responsibilities, e.g. checking that closings are carried out in accordance with fund documents • Permissible depositaries to include MiFID firms • Depository must have its registered office in the Member State in which the relevant AIF is established • For non-EU funds, depository must have its registered office in the EU, or be subject to equivalent regulation and AML requirements • Depository can delegate to a sub-custodian, but remains responsible • Depository to be liable only for unjustifiable failure or improper performance of functions
Transparency Requirements			
<ul style="list-style-type: none"> • Annual Report 	<ul style="list-style-type: none"> • Must prepare an annual report for each AIF, including audited financials and a narrative report, which is filed with the regulator 	<ul style="list-style-type: none"> • Annual report must also include remuneration details 	<ul style="list-style-type: none"> • Annual report must also include remuneration details
<ul style="list-style-type: none"> • Disclosure to Investors 	<ul style="list-style-type: none"> • Must provide detailed information to investors prior to investing and on any subsequent change 	<ul style="list-style-type: none"> • Must additionally disclose NAV and historic fund performance (where available) and use of leverage 	

	Original Proposal	Swedish Presidency Compromise Proposal (Council)	Draft Gauzès Report (European Parliament)
<ul style="list-style-type: none"> • Regulatory Reporting 	<ul style="list-style-type: none"> • Extensive regulatory reporting, including: <ul style="list-style-type: none"> ○ Illiquid assets and liquidity management arrangements ○ Risk profile and risk management ○ Use of short selling ○ Use of leverage 	<ul style="list-style-type: none"> • Must also disclose results of stress tests for risk management and liquidity management systems 	
<ul style="list-style-type: none"> • Portfolio Company Reporting 	<ul style="list-style-type: none"> • Applies where AIF acquires a 30%+ stake in a company other than an SME • Must disclose: <ul style="list-style-type: none"> ○ Identity of AIFM ○ Conflicts policy ○ Communications policy, especially regarding employees ○ Development plan for company (if unlisted) • Must prepare an annual report similar to that for a quoted company 	<ul style="list-style-type: none"> • Only applies where AIF has a controlling (50%+) stake • Additional disclosure to regulators and investors about levels of debt before and after acquisition • Requirement for disclosure of communications policy and development plan deleted • Disclosure of commercially sensitive information to employee representatives to be on a confidential basis 	<ul style="list-style-type: none"> • Only applies where AIF has a controlling (50%+) stake • Disclosure and reporting requirements for all companies to be harmonised up to the standards required by the AIFMD in order to ensure a level playing field
Leverage	<ul style="list-style-type: none"> • Must notify regulator if high levels of leverage are employed on a systematic basis • Must disclose leverage to regulator and investors • EU may impose limits on amount of leverage to be employed 	<ul style="list-style-type: none"> • Clarifies that these provisions apply only where leverage is used as part of investment strategy • Power to impose limits on leverage rests with national regulators, not EU 	<ul style="list-style-type: none"> • AIFM must set a leverage limit for each AIF managed, taking into account various key factors • Power to impose limits on leverage rests with new EU regulator

	Original Proposal	Swedish Presidency Compromise Proposal (Council)	Draft Gauzès Report (European Parliament)
Marketing	<ul style="list-style-type: none"> • Authorised AIFM can market EU funds to professional investors across the EU, subject to regulatory notification and approval • Member States may allow marketing to retail investors, but may be subject to additional requirements 	<ul style="list-style-type: none"> • Marketing restrictions to apply only to unsolicited offers 	<ul style="list-style-type: none"> • Marketing restrictions to apply only to unsolicited offers
Third Country Funds	<ul style="list-style-type: none"> • Authorised AIFM may market non-EU funds only if tax information exchange agreement is in place with the relevant jurisdiction • Non-EU fund managers may market within EU only if: <ul style="list-style-type: none"> ○ Domestic regulation, including capital requirements is “equivalent” ○ AIFM has obtained a “marketing only” authorisation from an EU regulator • MiFID firms not permitted to provide services to AIF that cannot be marketed under the Directive 	<ul style="list-style-type: none"> • Anti-avoidance provisions for master-feeder structures and funds of funds • Authorised AIFM may manage non-EU funds only if legislation in the relevant jurisdiction complies with international standards (e.g., IOSCO) and a regulatory cooperation agreement is in place • Member States may, but do not have to, permit authorised AIFM to market non-EU funds to professional (but not retail) investors under a domestic private placement regime • Non-EU fund managers cannot benefit from the AIFMD passport, but national private placement regimes should continue to be available • No restriction on MiFID firms providing services to AIF 	<ul style="list-style-type: none"> • Anti-avoidance provisions for master-feeder structures and funds of funds • EU professional investors entitled to invest “on own initiative” in a non-EU fund in accordance with existing national private placement regimes, but only if there is a cooperation and information sharing agreement in place between the relevant countries • Restriction on MiFID firms retained