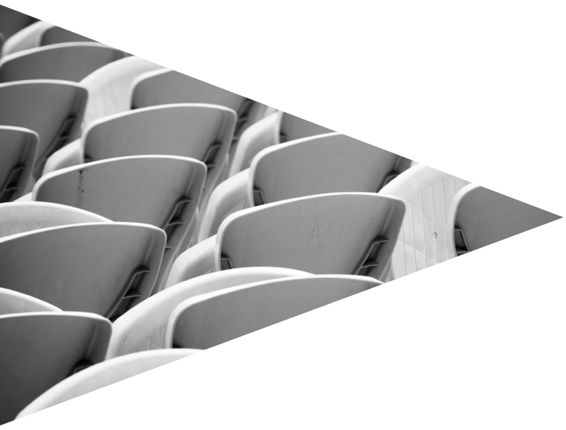
PE Alert

November 2010



AIFM Directive has passed – challenges and change for private equity fund managers going forward

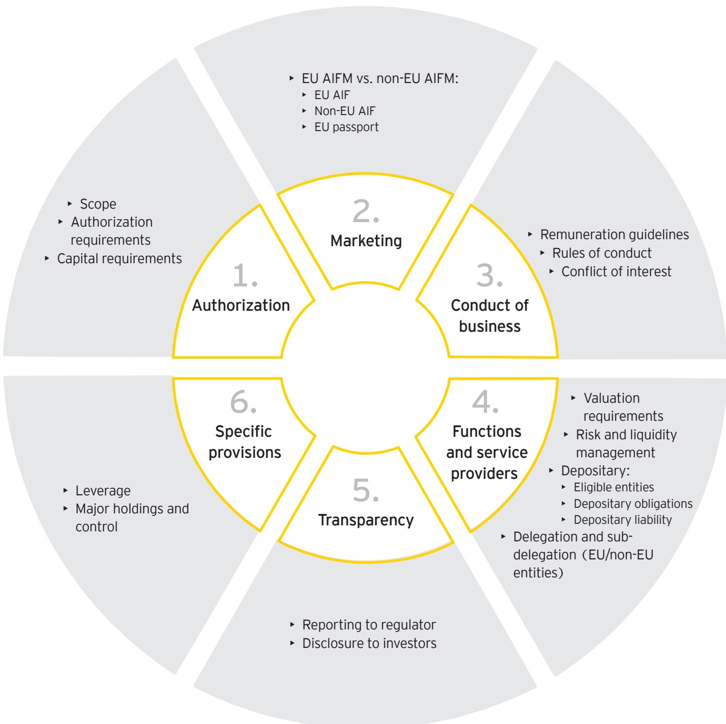
After more than 18 months of intensive debate, negotiations on the Alternative Investment Fund Managers (AIFM) Directive have reached a conclusion and the text passed during the European Parliament plenary session of 11 November 2010. Following publication in the Official Journal of the European Union, the two-year implementation phase across the European Union will start. This phase will see the technical guidelines for implementation being formulated, as well as implementation laws being drafted, all of which will require close monitoring from the private equity (PE) industry to ensure that the current framework translates into sensible and appropriate measures.

1. Background

The AIFM Directive (AIFMD) will, for the first time, introduce a harmonized European regulatory regime for managers of Alternative Investment Funds (AIF), including PE. From early 2014, existing EU PE AIFM will need to apply for authorization in order to manage AIF. Non-EU PE AIFM will also need to apply for authorization in order to manage EU AIF. In return for more regulation, the Directive provides for the introduction of a "passport" enabling AIFM to offer their management services and market their AIF throughout the European Union under just one single authorization.

To become authorized, an AIFM will need to ensure that it complies with a range of provisions within the AIFMD relating to effective governance, organizational structure, monitoring and safeguards, third-party oversight, financial resources and liability insurance cover, as well as meet enhanced reporting and disclosure requirements. We have illustrated the main areas covered by the Directive in the graphic below.

AIFM key provisions at a glance



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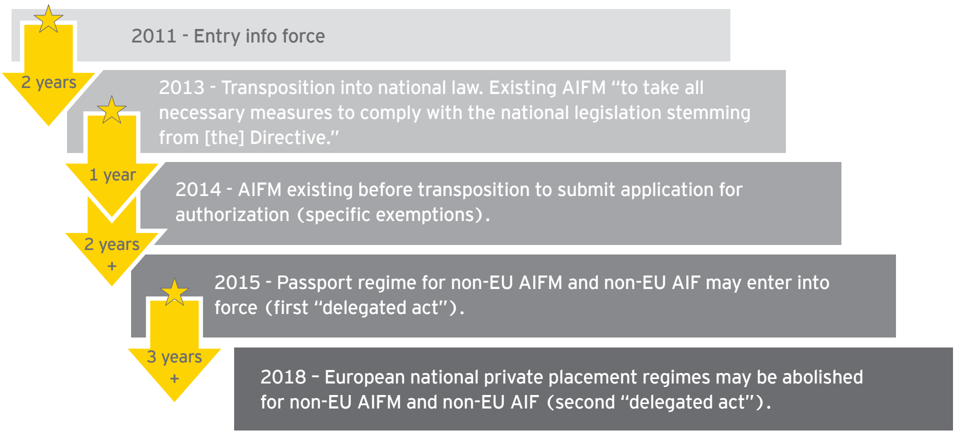
Some provisions apply solely to AIFM, such as capital requirements, rules of conduct, remuneration, conflicts of interest, risk management and marketing, while other provisions impact AIF even though they are not regulated directly. Provisions which impact AIF include those relating to depositaries, disclosure (including a compulsory annual report), as well as specific restrictions on distributions to the AIF from a controlled portfolio company during the first 24 months following its acquisition. Therefore, while the main focus of the AIFMD is on managers of funds, the Directive has a broad scope and will also impact EU and non-EU domiciled AIF, as well as service providers to these managers, funds and their investors.

The Directive provides for exemptions available to PE AIFM managing smaller portfolios of AIF[1] provided they register with the 'competent authorities' (e.g., financial services regulator) in their home Member State and comply with certain regulatory reporting requirements. However, any such AIFM wishing to benefit from the passport must voluntarily opt in to comply with the entire Directive.

2. Timeline for implementation



The Directive foresees some "grandfathering" provisions or transitional arrangements whereby the existing "legacy" regulatory requirements can apply for a period of time, or even in perpetuity for AIF meeting specific criteria, to the activities of AIFM. However, these grandfathering provisions are quite limited; the provisions most relevant to the PE industry are as follows:

- AIFM have one year after Q1/2-2013 (the "final transposition date" which is the deadline for all EU Member States to have transposed the AIFMD into national law) to "take all necessary measures to comply with national legislation stemming from the Directive" and to submit an application for authorization.
- AIFM managing existing closed-ended AIF that are fully invested by Q1/Q2-2013 may continue to manage such AIF without authorization under the AIFMD.
- AIFM managing any given closed-ended AIF which had its final close prior to Q1-2011 (the date of the AIFMD's entry into force) and which are constituted with a maximum life that requires it to be liquidated by Q1-2016 at the latest, may continue to manage such AIF without complying with most of the AIFMD, except for the provisions relating to producing annual reports and, if applicable, the obligations relating to the acquisition of major holdings and controlling interests in portfolio companies.

It is therefore worth noting that no specific grandfathering provisions are included for funds reaching a final close between the AIFMD's entry into force in Q1-2011 and its "final transposition date" in Q1-2013.

[1] AIFM that "manage portfolios of AIF whose assets under management, including any assets acquired through use of leverage, in total do not exceed a threshold of EUR 100 million" or "manage portfolios of AIF whose assets under management, in total do not exceed a threshold of EUR 500 million when the portfolio of AIF consists of AIF that are not leveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF." It is worth noting that the Directive appears to imply that typical PE funds do not offer such redemption rights, and also states that "delegated acts specifying how to calculate the thresholds for the lighter regime" will be released as part of the Level 2 guidance expected during the next 12 months.

3. Key new features relevant to the private equity industry

Since our May 2010 PE Alert ("Light at the end of the tunnel, but game not over yet ..."), two major changes have been introduced into the final text of the AIFMD, which are of particular relevance to PE.

Marketing under "same rights, same obligations" principle

The "third country" issue - the terms under which funds and managers based outside the EU can market to (i.e., raise funds from) professional investors within the EU, as well as conditions for investment by EU investors in non-EU funds – was the main point of contention, with a particular focus on passport eligibility for third country managers and funds, and potential restrictions on private placement regimes (PPRs) for investment in third country funds. Following intense negotiations, a compromise was finally reached, the main provisions of which are summarized here:[2]

- From Q1-2013, authorized EU AIFM will be granted a passport to market EU AIF to professional investors in their home Member State and in other EU Member States. They will no longer be able to use national PPRs for their EU AIF.
- For non-EU AIF managed by EU AIFM and non-EU AIFM marketing EU and non-EU AIF, two regimes will coexist for marketing: national PPRs, which may be phased out, and a passport regime, which may be phased in. The passport will not be available to non-EU AIFM or for non-EU funds before 2015, and the national PPRs will not be phased out before 2018. The expected adoption of the passport for third countries, and the potential phasing out of national PPRs are dependent on, amongst other things, an official opinion to be issued by the newly created European Securities and Markets Authority (ESMA), which will officially replace the Committee of European Securities Regulators (CESR) from 1 January 2011 — based in Paris.
- Non-EU AIFM intending to market AIF they manage in the EU using a passport must acquire prior authorization from their Member State of reference. This will require full compliance with the Directive or equivalent standards, as well as some additional conditions relating to cooperation arrangements, tax information-sharing, anti-money laundering provisions, and the nomination of a legal representative to act as a single point of contact within the EU.
- All marketing with a passport of EU and non-EU AIF to professional investors by EU and non-EU AIFM in home Member State/Member State of reference or another Member State is subject to a notification procedure.
- Member States will have discretion to permit marketing of EU and non-EU AIFs by AIFM to retail investors in their territory, and can apply stricter regulatory requirements to enhance the protection of such investors.

The compromise outlined above is based on the overarching principle of "same rights, same obligations" for all countries globally. To stay true to this principle, the Directive seems likely to create a fairly complex third country regime, under which significant power is granted to the upcoming ESMA. Whilst some details still need to be clarified, LPs will be relieved that:

- EU PPRs will almost certainly remain available to non-EU managers and non-EU funds for at least the next seven years.
- A passport for non-EU managers is expected to be made available from 2015 for managers wishing to distribute their products across the European Union upon receiving one single authorization.
- The Directive should not affect the status quo, where an EU professional investor may invest at its own discretion anywhere in the world.

Open questions relate, for instance, to how many non-EU countries will meet the requirement for "appropriate cooperation arrangements" to ensure the efficient exchange of information to enable robust systemic risk oversight, as well as anti-money laundering provisions required to market funds within the EU under national PPRs. A further open question is that if such arrangements do not exist, how long it will take to put them in place, and one possible outcome could be that individual Member States may amend their national PPRs in light of the Directive and its increased investor protection requirements. All of these factors could play in favour of "onshore" EU domiciles for funds, as well as managers.

Restricting "asset stripping" in portfolio companies

On the second controversial issue of anti-asset stripping provisions, the Directive introduces provisions that apply in respect of the acquisition of control[3] of both "non-listed companies" as well as "issuers." This is a concession to the European Parliament, which initially introduced this clause. SMEs (as per the standard EU definition) are specifically excluded, therefore the asset stripping rules should have a minimal impact on venture capital funds that invest exclusively in early-stage companies.

During the 24 months following the acquisition of control of an issuer or a non-listed company, an AIFM cannot facilitate, support or instruct any distribution, capital reduction, share redemption and/or acquisition of own shares by the company; where authorized to vote, the AIFM on

[2] For further details, please refer to our brochure, *A new dawn for alternative investments?*, or visit our website: www.ey.com

[3] "Control" is defined as more than 50% of the voting rights of a "non-listed company", and for "issuers" is defined by reference to the EU's Takeover Bids Directive.

behalf of the AIF shall not vote at the governing bodies of the company in favor of a distribution, capital reduction, share redemption or acquisition of own shares by the company and in any event use its best efforts to prevent the above events from occurring. Further provisions clarify when such restrictions are applicable, as well as to what is meant by "distribution" and "capital reduction." Provisions on capital reduction, for instance, do not apply in cases where such an exercise is undertaken from a restructuring perspective to offset losses.

The common theme of these provisions, which largely derive from the second company law directive, is to prevent shareholders (e.g., PE funds) from receiving distributions or returns of capital in the specific situations where they cannot be supported by the level of the company's net assets. They also aim to encourage PE funds to invest more equity into the underlying investee company.

To assess the potential impact on the PE industry of such provisions, it should first be noted that these restrictions only apply in situations where: the portfolio company is not an SME, the AIF has control, the effect of such a distribution, capital reduction, share redemption or acquisition of own shares would result in the portfolio company's net assets being lowered below the (fully called) "subscribed capital" plus legally non-distributable reserves and the distribution would exceed the amount of available profit. Generally speaking, this should not directly impact the PE business model, based on long-term investment and seems rather intended to dissuade corporate raiders. However, distributions will clearly not be possible where a fund acquires a distressed company with turnaround as its primary objective, particularly in the first two years, unless there is a remarkable turnaround which justifies a cash outflow from the investee company. Restructuring may also be affected in cases where the AIF would like to have a higher debt-to-equity ratio from a tax perspective, for instance.

But what about the issue of creating an unlevel playing field for PE-backed companies? By specifically placing restrictions on PE AIFM (on behalf of PE AIF) in relation to distributions, capital reductions, share redemptions, etc., the AIFMD does create an unlevel playing field vis-à-vis other companies (listed or private) which do not have any PE funds as shareholders. However, it should be noted that these provisions are in line with the second company law directive which is already applicable to all public limited liability companies.

4. Conclusion: what does this mean? How can Ernst & Young help?

Ernst & Young believes that the AIFM Directive is likely to have a profound structural impact on the PE industry globally. In particular, the Directive has ramifications that go far beyond achieving basic compliance to its provisions. PE houses (including General Partners, sponsors, advisers and managers of all types of PE funds), services providers as well as investors will all be impacted, although in different ways that need to be carefully assessed as the Level 2 guidance is released over the coming year.

Industry players falling within the scope of the Directive and willing to fully seize the opportunities of the new regulation as well as effectively address the challenges it poses should conduct a strategic review of their fund ranges, fund raising process and investor base as well as operating model to assess to what extent their current organization matches their future development goals.

Ernst & Young has put together a dedicated multidisciplinary team of experienced professionals to support you in this journey. We can provide assistance across our assurance, tax and advisory service capabilities including assessment of operational readiness against the Directive's key provisions using the EY AIFMD Diagnostic tool. Other services include stakeholder impact analysis, advice on any potential entity re-organization and structuring, upgrade of risk management frameworks including reporting, transparency, liquidity and valuation controls and systems, as well as review of depository arrangements (risk/selection/delegation).

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