

AIFMD

Impact on

Private Equity

*Navigating the
Regulatory Maze*

December 2010

AIFMD – Impact on Private Equity

Overview

The Alternative Investment Fund Managers Directive (AIFMD) subjects managers of alternative investment funds (AIFs) to compulsory regulation in the EU and will require significant modifications to the structures, strategies and operations of private equity (PE) fund managers and PE funds.

The EU Parliament approved the AIFMD on 11 November 2010 and it is expected to come into force in early 2013. Annex I sets out a timeline for the AIFMD implementation process, including the role of the new European Securities and Markets Authority (ESMA).

All PE managers will be affected by AIFMD significantly, except those non-EU managers who only manage non-EU AIF which are only marketed passively and do not actively seek EU investors. Even non-EU managers and in particular, those managing EU AIF (e.g. English LPs with a Channel Islands GP or Scottish LPs used as carry vehicles) will need to comply with the transparency and disclosure obligations as pre-requisites to continuing to market in the EU under national private placement regimes.

AIFMD is one of a host of regulatory developments which PE managers and their investment vehicles will have to adapt to over the next few years, including The Dodd-Frank Wall Street Reform and Consumer Protection Act, FATCA, EMIR and MiFID II. To find practical integrated solutions to the challenges posed by these multiple regulatory developments, managers will need to consider their strategic positioning, reassess their investment strategy in the light of the AIFMD, gauge their investors' continuing appetite for existing products given the current economic and regulatory environment, undertake gap analysis to identify areas for change, and plan for implementation. The cost consequences and resource needs should not be underestimated.

Managers need to begin now to analyse the operational consequences of AIFMD and these other significant regulatory developments on their business models and their products, on an integrated basis. Managers who react swiftly and effectively to the strategic opportunities offered by these developments can capitalise on the changing environment to gain competitive advantage.

Key challenges for PE

The PE industry will face a number of challenges in adapting to AIFMD, particularly in areas such as:

- Authorisation requirements and grandfathering provisions
- Capital requirements
- Fund structures and marketing
- Delegation and outsourcing
- Depositary requirements
- Valuation processes and procedures
- Compliance and other operational functions
- Disclosure and reporting requirements
- Anti-asset stripping restrictions
- Changes to remuneration structures

We consider these issues below, identifying the practical actions that PE fund managers will need to take to secure a market leading position when the full regulatory framework comes into force.

Authorisation requirements and grandfathering provisions

All EU domiciled PE fund managers will be affected by AIFMD – most will be required to comply fully with it. Managers with aggregate assets under management (AuM) of less than €100m leveraged or €500m unleveraged will be subject to a lighter touch registration and reporting regime. Those PE managers who are already authorised or operating in the EU have until January 2014 to comply fully with AIFMD.

The directive offers only limited grandfathering provisions, which will not benefit most existing EU AIFMs:

- Managers (including those using third country PE structures) who have only closed-ended funds that do not make any further investments after early 2013 will not be required to become authorised under AIFMD.

It is not clear how add-on investments affect this exclusion but we assume that they will constitute further investment and hence prevent a manager taking advantage of the grandfathering safe harbour.

- Likewise, managers with only closed-ended funds where the subscription period for new investors ends before January 2011 (even if drawdown of commitments occurs later) and which will terminate by 2016 are not required to become authorised.

As a first step PE managers may want to consider whether they wish to take advantage of these provisions through changes to their fund management structures.

Capital requirements

Many EU PE fund managers will face increased capital requirements under AIFMD, which establishes a minimum capital requirement of €125,000. If aggregate AuM exceed €250 million, additional capital equal to 0.02% of the amount exceeding £250m will be required, with the additional amount capped at €10 million. If the capital requirement under the Capital Adequacy Directive (CAD) is higher than that calculated under AIFMD, the capital requirement under CAD will apply. If performance fees and carry fees are expensed through the manager, the CAD figure could be substantially higher than the AIFMD requirement. Funds which are internally managed will have a minimum capital requirement of €300,000.

The increased capital requirements will push managers to reconsider the types of structures they will employ going forward, looking at alternatives to reduce their regulatory capital requirements. For example, GPs may be more likely to fully delegate discretionary management and marketing activities, to avoid having both the GP and the manager authorised under AIFMD, thereby reducing the capital burden.

A few issues around regulatory capital are still unclear, for example, whether value in any carry vehicles will count as AuM, and how should management fees and other costs be dealt with if a manager falls under CAD.

Fund structures and marketing

Most structures commonly used by PE funds will still be viable under the AIFMD. However, for those using limited partnerships, the respective roles of the GP and the manager, and the allocation of duties between

them, may shift. The currently common use of offshore GPs or managers running EU domiciled funds will still be feasible. However, these GPs will need to accept high levels of compliance with AIFMD when the “passport regime” is introduced in 2015, because even if the AIF is not being marketed, AIFMD requires the non-EU managers of EU funds to register under it from 2015. Non-EU managers may look to their EU investment advisors to help them comply with compliance burdens, but this will require careful thinking, particularly around possible tax issues.

From now until early 2013, existing and new funds can continue to be marketed under the current private placement regimes. From 2013, subject to the grandfathering provisions mentioned above, EU funds will be required to fully comply with AIFMD and obtain a passport to market cross-border in the EU.

For non-EU managers and non-EU funds, from 2013 until at least 2018, existing country by country private placement regimes will remain available for marketing of fund interests across the EU. Non-EU funds will have to comply with certain disclosure and reporting requirements and, particularly pertinent in the PE space, the additional disclosure requirements and the anti-asset stripping rules. In addition, they will need to ensure they are operating in a jurisdiction whose regulator who has put in place regulatory cooperation agreements with the Member States where the fund is to be marketed. Key off-shore jurisdictions such as Jersey, Guernsey and the Cayman Islands have indicated their political intention to do so, to allow “business as usual” for funds and managers domiciled in those jurisdictions.

In addition to the private placement route to market, from 2015, provided ESMA creates the necessary regulatory superstructure, non-EU funds will be able to take advantage of a passport regime, provided regulatory cooperation agreements are in place, the third country has appropriate anti-money laundering and anti-terrorist financing laws and regulations, a network of OECD model tax information exchange agreements is in place, and the non-EU fund manager complies fully with the AIFMD regime (to the extent legally permissible under its own laws) and obtains authorisation from a Member State of reference for its marketing activities in the EU.

Passive marketing (a.k.a. “reverse solicitation”) is not covered by the AIFMD, so managers who do not actively solicit EU investors in the EU and who are happy simply to be sought out and accept participations which are agreed outside the EU will be unaffected by AIFMD. We will need more clarity,

though, around the definitions of passive marketing and the negotiation and subscription process for agreeing the terms of investor participation through the passive route. For example, if the initial contact is made “outside” the EU, whether subsequent contractual negotiations can be treated as not constituting marketing.

Delegation and outsourcing

Managers will continue to be able to delegate functions, including portfolio management (subject to giving advance notice to their regulator) and risk management. Delegates taking on portfolio or risk management responsibilities will generally have to themselves be an authorised asset manager and subject to supervision and, where the delegate is based in a non-EU country, regulatory cooperation agreements must be in place. Further sub-delegation is permitted, subject to the conditions above and manager consent. For many off-shore PE managers, this will not be a substantial concern, as they will generally be the outsourcers, rather than the other way round.

Depositary requirements

Currently many PE fund managers do not have any external formal custody arrangements, as the assets they hold do not require a traditional custodian. However, going forward PE funds will be required to appoint a single independent depositary to safeguard a fund’s assets. The depositary must be independent of the fund manager. For EU funds, the depositary has to be based in the fund’s Member State.

Member States will be able to permit closed-ended PE funds to appoint depositary entities which are not banks or authorised investment firms but which carry out depositary activities as part of their professional activities, such as law firms, administrators and notaries. For many PE houses affected by this requirement, this should reduce the costs of outsourcing this function.

For non-EU funds, the depositary can be an EU credit institution or a credit institution or investment firm from the fund’s domicile or the home member state of the manager, provided the local depositary is subject to effective prudential regulation and supervision having the same effect as EU laws and which are effectively enforced. Regulatory cooperation agreements and tax information exchange agreements will need to be in place between the third country and each Member State where the fund is marketed, and the country must not be on the FATF list of non-cooperative countries. The third country depositary will have to be contractually liable to the fund or the investors. It is not clear from the AIFMD whether or

not non-EU funds will be permitted to use local administrators or lawyers as their custodians but hopefully this will be made clear in the Level 2 implementing measures.

AIFMD contains extensive provisions on the depositary’s role and responsibilities, its ability to delegate and its liability to the fund and investors (the harsher strict liability provisions previously proposed have been avoided).

PE houses will need to begin to consider how the depositary requirements will affect their existing and future funds and plan for the appointment of third party providers where those are not already in place. Contractual arrangements with depositaries and administrators will need to be reviewed and revised (where already in place) to comply with the new regime or new ones put in place. The extent of potential involvement of depositaries in the day to day activity of a PE fund should not be underestimated, as under AIFMD they are responsible for verifying the ownership of assets as well as monitoring transactions between the fund and investors, which will entail much greater involvement than previously.

Valuation processes and procedures

AIFMD requires all managers to have a robust objective valuation process that can be performed by an external valuer or internally. PE managers have traditionally carried out many valuation activities themselves, and will be able to continue to do so under AIFMD. However, they will be required to ensure that valuation functions are performed independently from the portfolio management function (i.e. by separate staff). Assets of each fund will have to be valued and the NAV calculated on an annual basis and any time the capital of the fund is increased or decreased. These provisions need urgent amplification at Level 2, as it is unclear whether this implies that, for example, each time there is a capital draw down, a PE fund might need to have the underlying fund assets revalued, which would appear unnecessary. If the PE manager carries out valuations internally, its regulator will be able to require it to have its valuation procedures and/or its valuations verified by an external valuer or auditor.

Fund documentation will need to be updated to reflect these requirements and the potential costs of external verification may have to be factored into cost models.

External valuers will have unlimited liability to the manager for any errors or omissions, which cannot be contractually capped. The threat of uncapped liability may make some service providers reluctant to

provider a formal valuation and limit their role to providing advisory services only.

Compliance and other operational functions

AIFMD will force PE managers to review their compliance and operational functions, in particular in relation to the identification and management of conflicts of interest and risk management.

Operational resources are likely to need to increase to cope with the increased burden in this area as well as the increased disclosure and reporting obligations PE managers will bear. Identification of conflicts of interest will require managers also to consider relationships and potential conflicts of interest with and between portfolio companies, requiring policies and procedures to be updated.

Disclosure and reporting requirements

PE managers have an obligation to make full disclosure to investors (before they invest), including a description of the investment strategy and objectives of the AIF, the types of assets which the AIF may invest in, investment techniques it may employ, and procedures to be used to alter the investment strategy.

The ongoing disclosure requirements are extensive as internal and external reporting, including gearing, liquidity, risk management, trading activity and, for PE managers, information about portfolio investments, will be required of an AIFM to investors and the PE manager's competent authority. In practice, this means producing an audited annual report for each AIF. The competent authority may request a detailed quarterly list of all AIFs an AIFM manages. Furthermore, ad-hoc reporting may be required if necessary for effective monitoring of systemic risk. For UK PE houses, much of the reporting will be familiar, and consistent with that required by the Walker Report.

Currently, PE funds investing in non-listed companies are bound by the same national laws on shareholder disclosure obligations as any other investor in companies of the same size. AIFMD introduces extra disclosure requirements at PE manager level. These disclosure obligations will generally apply to PE managers who either individually or collectively use individual or pooled funds to acquire control (more than 50% of the voting rights) of a company. AIFMs that buy small or medium enterprises (namely companies that satisfy two out of the following criteria: (1) fewer than 250 employees and/or (2) an annual net turnover not exceeding €50m and/or (3)

a balance sheet not exceeding €43m). Real estate special purpose vehicles are exempted from this requirement.

PE managers will be required to provide the competent authority, the non-listed company, its shareholders and employees with information about itself, its policy regarding conflicts of interest and its communication policy. Additionally, the company and its shareholders must be made aware of the manager's future intentions regarding the company and the likely repercussions for employees. The manager must also use its best endeavours to ensure that the board of the investee company passes this information to the employees. AIFMs must also procure that relevant past and likely future developments are taken into account in the company's annual report.

These disclosure obligations go beyond current requirements and may be discriminatory and uncompetitive as other buyers (e.g. trade purchasers, family offices and sovereign wealth funds) will not be subject to the same requirements. The requirement for the publication of development plans for the underlying portfolio companies is particularly problematic as it may lead to obligatory disclosure of strategically confidential information.

Managers will need to anticipate requirements for more resources (staff and systems) and planning around presentation of strategic information to cope with these increased disclosure requirements.

Anti-asset stripping restrictions

One of the most controversial aspects of the directive relates to the anti-asset stripping provisions that have been introduced in respect of the acquisition of "control" of both non-listed companies and issuers. "Control", as mentioned earlier, is defined as 50% of the voting rights of a non-listed company and for issuers is defined by reference to the EU's Takeover Bids Directive.

The basic provisions state that during the 24 months following any such acquisition, an AIFM cannot facilitate, support or instruct any distribution, capital reduction, share redemption and/or acquisition of own shares by the company. Also, where authorised to vote, the AIFM cannot vote in favour of any such activity, and is furthermore obliged to use its best efforts to prevent such events from occurring.

However, further provisions in the directive clarify when these restrictions apply in practice, together with providing clarification on what is actually meant by, for example, the terms "capital reduction" and

"distribution". Only distributions, capital reductions, share redemptions (etc) which result in the portfolio company's assets falling below its fully subscribed capital plus its non-distributable reserves, and where such exercise would exceed the amount of available profit, are restricted. The outcome of this is that these restrictions will not apply where exercises involving the above take place as part of a restructuring exercise to offset losses. It should also be noted that SMEs are specifically excluded - an important exemption for venture capitalists.

Although not as onerous as previously feared, these provisions clearly put PE backed companies at a disadvantage to other companies which do not have PE funds as shareholders. Overall, the application of these provisions is an important consideration for PE fund managers. In planning for acquisitions, they will need to take into account these restrictions and consider what pre and post-acquisition measures may be available to alleviate their impact on returns if their activities are caught by the restrictions.

Changes to remuneration structures

With respect to EU AIFMs, AIFMD will require the deferral of performance related payments, participation in equity based compensation and reward policies that align bonuses to the wider strategy of the business. This requirement applies to senior management, portfolio managers, staff with responsibility for risk management and other high earning staff of the PE house who have a material impact on the risk profile of the manager's funds. For example, managers will be required to defer for an "appropriate" period at least 40-60% of the bonuses and carried interest of affected staff. In addition, managers will have to establish and maintain remuneration policies and practices that are consistent with and promote sound and effective risk management.

These provisions may significantly impact the carried interest structures of typical PE funds, but just how they will be applied in relation to PE remuneration structures will not be clear until the Level 2 implementing measures are available.

Managers should begin considering their remuneration arrangements now to understand how and who may be affected and will need to update their incentive scheme strategy prior to implementation of AIFMD to ensure that their reward structures remain commercially attractive and tax effective, as well as being compliant with AIFMD.

How can PwC help?

PE managers need to consider a number of issues now:

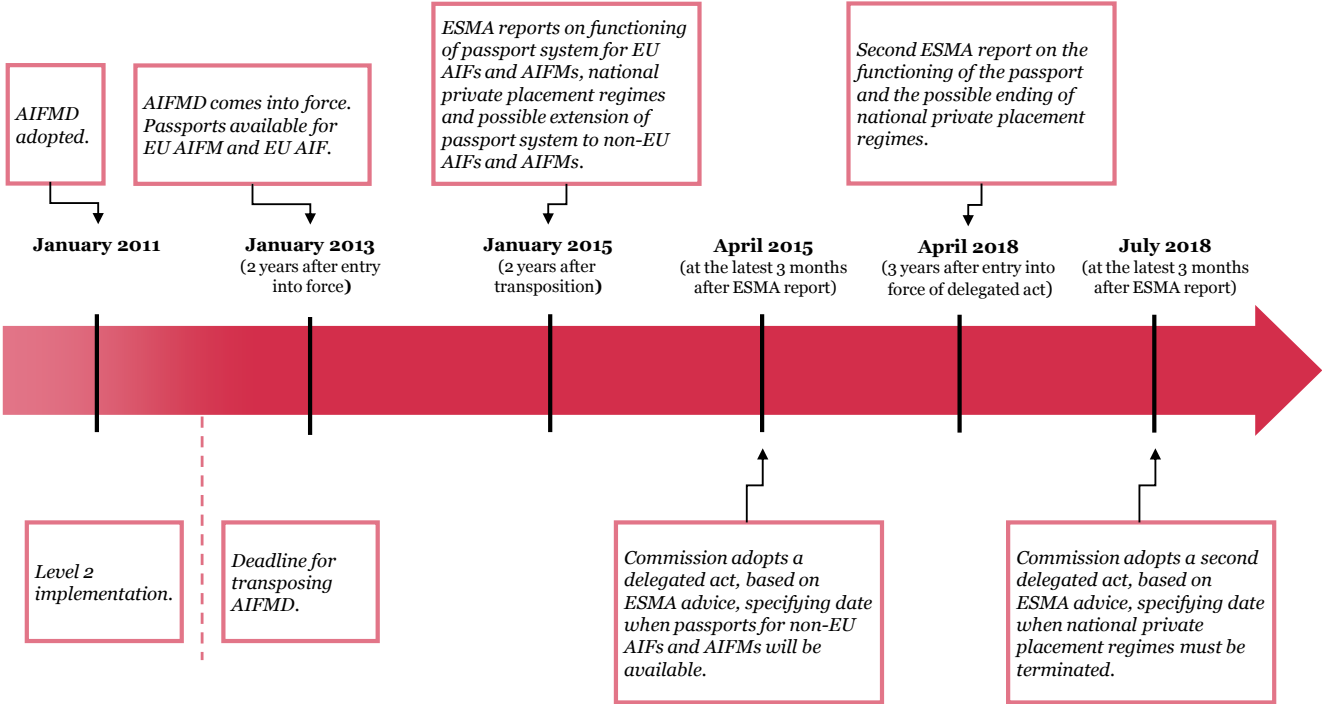
- What will our organisation need to do to comply?
- What is our current state of preparedness?
- If we adapt our existing business model to comply with AIFMD, what are the implications for our management company and fund structure?
- Should we outsource certain activities?
- How does my business mode work compared with my competitors (EU and non-EU)?
- Are we doing business and managing our funds in the right locations?
- Are our existing funds affected by AIFMD?
- What will the impact on our resources and systems be?
- Are there unintended tax consequences, for example increased permanent establishment risk in certain jurisdictions?

We can work with you to assess the impact of AIFMD on your business. You will have access to the industry knowledge accumulated across our leading PE management practice, together with recognised experts in strategy, law and regulation, capital requirements, compliance, tax, remuneration, operations and structuring. Our collaborative methodology will be used to establish a framework for your AIFMD solution, tailored to your business requirements, by helping you with:

- completing gap analysis and impact assessments;
- defining strategic objectives and planning;
- designing and constructing solutions;
- implementing agreed actions; and
- ensuring effective operation, validation and ongoing review.

By working with you through the AIFMD analysis, we can assist you in managing its potential cost and resource requirements, to best exploit the opportunities presented by the new regulatory environment.

Annex I: Timeline



Annex II: PwC AIFM CI Contacts



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