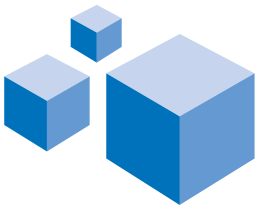

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AIFMD: Private Equity

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A Introduction

As is widely known by now, the AIFMD, although apparently prompted by certain perceived issues arising out of the hedge fund and prime brokerage industries, casts a very wide net, and applies in principle to the management and marketing in the European Economic Area ("EEA") of practically any form of investment fund, except those subject to the so-called UCITS Directive (i.e. in effect, retail mutual funds authorised in the EEA). The private equity industry is therefore not immune from its reach.

The AIFMD affects those private equity fund managers who manage alternative investment funds ("AIFs") with unleveraged assets of above €500m (a private equity fund), there being an exemption for managers who manage unleveraged assets of below €500m (provided there are no redemption rights within five years of initial investment in the AIF). Please see below for the methods of calculating leverage. Note that, in a private equity context, leverage will not include the borrowings or other leverage of any entity in which the private equity fund invests, as long as the fund is not liable for any amounts (for instance, under any guarantee obligation) beyond the amount of its investment.

The level 2 delegated Regulation (the "Level 2 Measures"), adopted by the European Commission on 19 December 2012, provides detail on the implementation of the AIFMD and the consultation paper published by HM Treasury in May 2013 transposing the AIFMD into national law, set out the government's approach towards a number of policy decisions, including how to apply the AIFMD to private equity fund managers. The final regulations, the Alternative Investment Fund Managers Regulations 2013, were published in July 2013, of which Part 5 of the Regulations (Sections 34 – 44 inclusively) applies to private equity. These provisions cover matters concerning disclosure obligations and asset stripping in relation to control, which are briefly described in the following summary.

B What are the objectives of the AIFMD?

The two main objectives of the AIFMD are:

i to provide a clear and consistent framework for the regulation and supervision of AIFMs in the EU;

and

ii to ensure a high level of investor protection in the EU.

The Level 2 Measures aim to achieve these core objectives by creating a single rulebook for all AIFMs to ensure a level playing field and dealing with the following issues:

- a common approach to calculating assets under management ("AUM") and leverage;
- a common approach on an AIFM's level of additional own funds and level of PI insurance required by AIFMs (operational continuity);
- general operating conditions for AIFMs, including general principles, conflicts of interest, risk management, liquidity management, investment in securitisation positions, organisational requirements, valuation and delegation of AIFM functions;
- a common approach on the scope of custody and on the depositaries' liability to return financial instruments lost in custody;
- a common approach to transparency of AIFMs towards investors and supervisory authorities;
- a common approach to co-operation with third countries; and
- a common approach to an AIF's reporting frequency and exchange of information on the potential systemic consequences of AIFM activity.

C Who is an AIFM and what is an AIF and what must they do?

The AIFMD applies to EU-based fund managers, wherever their funds are based, and non-EU-based managers who either manage or market one or more AIFs in or into the EU.

An AIFM is anyone who, at a minimum, either performs portfolio management services or risk management services for an AIF and an AIF means virtually any fund, regardless of structure, jurisdiction or investment strategy, other than a UCITS fund.

The AIFM may delegate its portfolio management or risk management duties if it wishes but not to the extent that it becomes a mere "letter-box entity", and accordingly may not do so to a "substantial margin". It must also manage the risks attaching to the delegation, and remains responsible to investors for the activities delegated by it. The effect of these provisions is that, even where portfolio management activities are delegated in their entirety, an AIFM must have sufficient resource and expertise to supervise and manage the risks of the activities delegated. The Level 2 Measures give detailed requirements for the delegation process and delegation contracts and delegation is discussed in more detail below.

Where the AIFM carries out both risk management and portfolio management, it must maintain a separation between the two and have satisfactory hierarchical arrangements in place.

The AIFM will be required to carry out its duties in accordance with the rules of the AIFMD and general operating conditions. Please see below, where more details are given.

AIFMs must also comply with capital adequacy requirements by holding a certain amount of own funds, either in cash or by insurance policy or a combination of the two. More details are given below.

The AIFMD also contains requirements relating to the remuneration of senior management and certain key staff, and in particular the treatment of variable and deferred remuneration, which must be implemented by the AIFM. While these provisions are broadly similar to those in the Remuneration Code, with which FCA-authorised private equity fund managers are already likely to be familiar, they are not identical, and are not free from interpretational problems (which have not been removed by the Level 2 Measures) as to how they apply to normal private equity practice.

While, as stated above, there are exemptions to the AIFMD, even exempt managers (i.e. those below the threshold of aggregate AUM, which for private equity fund managers will generally be €500 million) are subject to registration under the AIFMD. In the UK, this means that managers have to register themselves and their funds with the FCA and provide information on their investment strategies, the main instruments in which they trade and their principal exposures and concentrations. They will also have to notify the authorities if they no longer fall below the relevant threshold within 30 days of exceeding the threshold, at which point they will need to apply for authorisation as an AIFM. For a typical FCA-authorised private equity fund manager, this means extending the manager's permissions to include acting as manager of AIFs.

It is worth noting that a manager who, though FCA-authorised, is below the threshold and therefore merely registered with the FCA for AIFMD purposes will not be entitled to any of the passporting rights as regards the marketing of that manager's funds into other Member States. In appropriate cases, it may therefore be worth considering voluntarily opting into the AIFMD, even where a manager is sub-threshold.

D What about the AIF and its other service providers?

While the AIFM will need to consider the implications of the AIFMD, so will certain key service providers, most notably administrators and custodians, whose contractual documentation and roles are significantly impacted. Please see below for a summary of the rules in relation to depositaries: as many private equity funds have historically operated without custodians, the depositary function will

be a new requirement for them and necessitate the addition of a service provider.

E What action is needed now?

Please see our Checklist for Private Equity Managers. To summarise briefly, AIFMs need to liaise with their lawyers to:

- keep track of the FCA's issue of application forms for application for authorisation under AIFMD (or extension of existing permissions) and then complete and submit the forms when they are available;
- decide who will conduct risk management and portfolio management, and how;
- review and negotiate administration agreements and appoint a depositary, or amend any existing custodian agreement, to meet depositary rules;
- update offering memoranda and all marketing documentation;
- put in place internal and compliance procedures; and
- put in place reporting procedures.

F Summary of the main articles

Calculation of assets under management (Arts 2 – 5)

In accordance with Article 2 of the Level 2 Measures, the AIFM has to calculate total AUM by determining the value of all assets it manages, without deducting liabilities, and valuing all financial derivative instruments at the value of an equivalent position in the underlying assets (so as to reflect the AIF's exposure to those assets).

This calculation must be made at least annually, using the calculation methodology set out in the Level 2 Measures, and must be communicated to the competent authorities.

AIFMs are then required to monitor AUM on an on-going basis and action must be taken when thresholds laid down in the AIFMD are occasionally breached. In a private equity context, the calculation of AUM is not required to take account of any undrawn capital commitments. However, draw-downs - and indeed distributions- will affect AUM and therefore need to be monitored, and their effect on AUM considered as they arise.

Additional own funds and PI insurance (Arts 12 – 15)

The AIFMD requires AIFMs to hold appropriate additional own funds or PI insurance to cover potential liability risks arising from professional negligence, such as a breach of legal or regulatory obligations, confidentiality or fiduciary duties, improper valuation of assets, operational procedural failures or misrepresentation.

The Level 2 Measures specify the appropriateness of cover: additional own funds should represent at least 0.01% of the value of portfolios of AIFs managed and PI insurance should cover an individual claim of at least 0.7% of the value of portfolios of AIFs managed and 0.9% of the value of portfolios of AIFs managed for claims in aggregate per year.

The AIFM shall be obliged to implement effective internal risk management policies and procedures to monitor the professional liability risks to which the AIFM is or could be exposed, which must be subject to at least annual review, and to monitor the value of portfolios managed on an on-going basis.

Many private equity fund managers caught by the AIFMD may find that they have to increase their capital in any event to take account of the basic requirement that an AIFM must have €125,000 of capital, plus additional own funds of 0.02% of the amount by which AUM exceeds €250 million (to a maximum total capital requirement of €10 million).

General Operating Conditions (Arts 16 – 82)

Articles 12 – 20 of the AIFMD require AIFMs to operate under certain harmonised conditions and the Level 2 Measures clarify and expand in detail the duties and obligations of AIFMs, and also specify the criteria to be used by competent authorities to assess the manner in which AIFMs operate, in respect of the following:

- general principles and conflicts of interest (Arts 16 – 37);
- risk management (Arts 38 – 45);
- liquidity management (Arts 46 – 49);
- investment in securitisation positions (Arts 50 – 56);
- organisational requirements (Arts 57 – 66);
- valuation (Arts 67 – 74); and
- delegation of AIFM functions (Arts 75 – 82).

Turning in brief to some of these points:

The Level 2 Measures lay down rules for a conflict of interests policy which AIFMs should implement, a risk management system to be established and applied, an appropriate liquidity management system to be adopted, policies and procedures for the valuation of assets to be established and maintained and a well-documented organisational structure to be established for the proper management of AIFs, including administrative and accounting procedures and adequate internal control mechanisms.

The AIFM must ensure that the governing body, the senior management and, where relevant, the supervisory function, are responsible for the AIFM's complying with its obligations under the AIFMD.

The Level 2 Measures have considerably expanded upon delegation of AIFM functions and provided clarification upon the issue of the "letter-box entity", which generated much discussion during the drafting stage. Article 75 does permit AIFMs to delegate functions (subject to supervision of the delegate and management of the associated risks), but AIFMs are expected to show "objective reasons" for the delegation and are not allowed to delegate in such a way as to alter their obligations or circumvent liabilities.

Article 82 prohibits a manager from becoming a mere "letter-box entity" i.e. an AIFM is prohibited from delegating to an extent that exceeds by a "substantial margin" the investment management function performed by the AIFM itself, but it will also be regarded as a letter-box entity if it no longer has the necessary resources or expertise to supervise the activities it has delegated, or has no power to take decisions in key areas, or no contractual rights to inquire of, inspect, gain access to or instruct its delegates.

In this context, it has never been wholly clear how the AIFM concept applies to the general partner of a typical private equity fund structured as a limited partnership. In the standard such structure, the general partner, although legally responsible for the management of the limited partnership, delegates the entirety of its duties to a fund management firm, which (in the UK at least) will typically be FCA authorised. The working assumption must be that the AIFM in such a structure would be the fund management firm and not the general partner, given that the latter will generally retain none of the portfolio or risk management functions regarded by AIFMD as inherent to the nature of the AIFM. General partners, therefore, should not require authorisation or be affected themselves by the obligations imposed on AIFMs by the AIFMD, as long as their funds have a duly authorised AIFM who carries out the AIFM functions.

Furthermore, AIFMs will also need to look at where they delegate, as there are certain restrictions on delegating to delegates in countries outside the EEA which do not have cooperation agreements with the relevant EEA Member State.

Confidential information (Art 39 of the Level 2 Measures)

Article 39 of the Level 2 Measures reflects Article 58 of the AIFMD and provides that if information is provided in confidence by an employer, the employee (or his representative or expert) will be subject to the requirements of regulation 25 of the Information and Consultation of Employees Regulations 2004.

Acquiring control of a non-listed company (Arts. 40 – 44 of the Level 2 Measures)

Articles 27 to 29 of the AIFMD impose obligations upon an AIFM to provide certain information to the competent authority when it acquires control of a non-listed company or issuer. These are

transposed in sections 40 – 44 of the Regulations and the Financial Conduct Authority (FCA) is the competent authority for these purposes (see *Art. 46*).

Article 40 states that when an AIF acquires, disposes of or holds shares of a non-listed company, the AIFM must notify the FCA of the proportion of voting rights of the non-listed company held by the AIF at any time when that proportion reaches, exceeds or falls below the thresholds of 10%, 20%, 30%, 50% and 75%. Such notification must be made no later than 10 working days after the relevant threshold is crossed. Notification to the FCA by the AIFM is also required when an AIF acquires control of a non-listed company, control being defined as holding more than 50% of the voting rights (see *Art. 38*).

Article 41 lists the general information required to be disclosed by the AIFM upon the AIF acquiring control.

Article 42 specifies the additional disclosures required of the AIFM upon the AIF acquiring control of a non-listed company, namely notification to the company and its shareholders of the future business and the likely repercussions on employment by the company, including any material changes to the conditions of employment. Additionally, the AIFM must provide the FCA and the AIF's investors with information on the financing of the acquisition.

Article 43 provides a carve-out to the disclosure obligations in Articles 40 – 42 where the communication would seriously harm the functioning of or be seriously prejudicial to the company.

Section 44 sets out what information the AIF must provide in its annual report in respect of the non-listed company which it controls.

Asset Stripping (Art. 45 of the Level 2 Measures)

Article 45 of the Level 2 Measures reflects the asset stripping restrictions set out in Article 30 of the AIFMD and provides that for a period of 24 months after an AIF acquires control of a non-listed company, the AIFM must not facilitate, support or instruct any distribution, capital reduction, share redemption or acquisition of the company of its own shares or vote in favour of such action and must use its best efforts to prevent any such action.

Depositaries (Arts 83 – 102)

The consultation paper notes that the government proposes to exercise the derogation provided by Article 21(3) of the AIFMD, which allows certain entities other than credit institutions to be a depositary for certain AIFs with a five-year lock up period. The reason given for exercising the derogation is to support a competitive market for private equity AIFMs. Those entities wishing to provide depositary services will be required to hold the permission of "acting as the depositary of an AIF" but will be subject to appropriate depositary requirements. This provision is in effect an acknowledgement of the fact that, typically, private equity funds (and certain other types of fund invested otherwise than in listed securities or other assets generally held in custody) have operated without the type of custody arrangements entered into by securities funds, and indeed often without custodians at all. It remains to be seen however whether other entities (for instance, administrators) choose to enter into this potential market.

Transparency of AIFMs (Arts 103 – 110)

The extensive disclosure requirements laid out in the Level 2 Measures cover disclosures in annual reports, disclosures to investors generally and periodic disclosures to competent authorities.

The provisions relating to the annual reports impose a number of extra disclosure requirements, such as the need to disclose remuneration and carried interest, as well as material changes over the previous year.

Periodic disclosures of various matters also need to be made to investors, for example changes in maximum leverage levels and the risk profile and risk management systems employed by the AIFM. These matters need to be disclosed at

the outset in the offering document, and, at a minimum, also in the annual report and in any other periodic reporting to investors.

There is also a significant list of matters which are required to be disclosed periodically - whether quarterly, semi-annually or annually, depending on the size of the AIFM - to the competent authorities. These include the principal assets invested in, with sectoral and geographic breakdowns, where they are invested in and any principal exposures or concentrations, the risk profile of the AIFs, special liquidity arrangements (generally less relevant to private equity than to hedge funds) and the results of the periodic stress tests which the AIFMD requires AIFMs to carry out.

Co-operation with third countries (Arts 113 – 115)

The AIFMD requires co-operation arrangements to be established between European competent authorities and supervisory authorities from the country of origin of a non-EU AIFM or a non-EU AIF.

Some aspects of these arrangements are specified in the Level 2 Measures in order to design a common framework to facilitate the establishment of such co-operation arrangements with third countries. These arrangements must establish such mechanisms, instruments and procedures as are required to enable third country competent authorities to assist the EU to enforce EU legislation and national implementing legislation which is breached by a third country entity.

The Level 2 Measures also require the arrangements to include a data protection safeguard in line with the AIFMD. Where third countries are unable to sign such co-operation agreements meeting the minimum requirements, there will be restrictions on marketing, managing and delegation in relation to such third country.

Exchange of information relating to potential systemic consequences (Art 116)

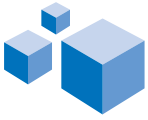
Article 116 specifies the exchange of information between the competent authorities of the Member States, European Securities and Markets Authority and the European Systematic Risk Board which is required under the AIFMD for the purpose of identifying potential systemic consequences of AIFM activity.

G Next Steps

The Level 2 Measures have significant ramifications for many AIFMs who either operate in the EU or manage any AIF in, or market one into, the EU and AIFMs should actively review what they need to do in order to become compliant with the requirements of the AIFMD, whether in terms of their actual operations, and the division of functions within those operations, or their documentation and disclosure arrangements.

We have produced an AIFMD checklist for private equity managers which (along with other AIFMD resources) is available on our website under "Publications". A 25 minute podcast on the AIFMD is also available as a download from our website under "Webinars and podcasts".
To discuss how the AIFMD might affect you, please contact Claire Cummings at claire.cummings@cummingslaw.com or on 020 7585 1406.

This document is for general guidance only. It does not constitute advice.
February 2014



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