

Private equity's albatross | BY CHRISTOPHER A. ROSE AND KEVIN T. CONNOR

In the eyes of the EU Commission, it would appear that all 'funds' should share equal responsibility for causing the credit crunch, regardless of culpability. This was evident in a recent proposed directive which, if adopted, would heavily regulate alternative investment fund managers (AIFMs). AIFMs, as currently contemplated by the directive, include both hedge fund managers and private equity fund managers, despite the fact that these two groups share little in common other than one word in their respective names.

Interestingly, the EU commission itself admitted in the proposed directive that private equity "did not contribute to increase macro-prudential risks". Nevertheless, private equity now must sink or swim with the weight of the hedge fund industry chained around its neck. Private equity managers and investors, not surprisingly, are in an uproar. Based on the current draft of the EU directive, they may not be overreacting.

The directive provides for extensive regulation over managers of funds, including authorisation to manage, administer and market funds. If adopted, the legislation would effectively prevent investors from investing in AIFMs run by non-EU managers. Moreover, fund managers would be required to comply with ongoing disclosure requirements regarding themselves and the funds they manage, maintain minimum capital levels and strictly monitor and disclose liquidity requirements

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relating to the funds they manage. The directive makes reference to the 'competent authorities' who will be responsible for overseeing the implementation of the regulations, but it is currently unclear who will play this role in each EU Member State.

Perhaps even more worrisome is that, even before the directive was released, advocates of the regulations criticised the draft as being too weak because it regulates only fund managers, rather than the funds themselves. These critics also attacked the directive for exempting certain fund managers and for failing to adequately limit leverage exposure or create strong enough capital requirements. On the other side, trade associations representing both the hedge fund and private equity industries have criticised the proposed directive as being an ill conceived political reaction to the current global financial crisis.

The remainder of this article highlights some of the principal areas intended to be regulated by the proposed EU directive. Further changes are anticipated before it is adopted, a process that could take up to two years.

Who is covered

The proposed directive applies to any legal or natural person established in the European Union (the Community) whose regular business is to manage one or several alternative investment funds domiciled inside or outside the Community.

An alternative investment fund (AIF) is defined as any collective investment undertaking created for the purpose of investing in assets, and not otherwise regulated under the UCITS Directive, the current collective investment fund regulations.

Who is not covered

First, AIFMs whose aggregate AIF portfolio has less than €100m in assets under management or less than €500m in assets under management if the AIF portfolio is not leveraged and shares cannot be redeemed within five years of the AIF's 'date of constitution' are not covered. Second, AIFMs who are not established in the European Union. Finally, AIFMs established in the European Union who do not manage or market AIFs in the EU.

What is required

Authorisation. Entities not authorised under the proposed directive may not provide AIF management services to AIFs or market AIFs in the Community. To be authorised, AIFMs must demonstrate their qualifications. This process includes providing detailed information on their planned activities, internal operations and AIFs that they manage or intend to manage. Once authorised by a Member State, AIFMs can manage and market AIFs throughout the Community. To be authorised, AIFMs must demonstrate their qualifications. This process includes providing detailed information on their planned activities, internal

operations and AIFs that they manage or intend to manage. Once authorised by a Member State, AIFMs can manage and market AIFs throughout the Community. EU Member States can authorise AIFMs established in non-EU countries to market AIFs to professional investors domiciled in an EU Member State so long as that country has equivalent regulations and supervision.

Minimum capital requirements. AIFMs must maintain capital of at least €125,000. The minimum capital requirement increases by 0.02 percent of the amount that the AIFM's AIF portfolio exceeds €50m.

Valuation. AIFMs must ensure that all assets and shares of the AIFs in their portfolios are valued by an independent auditor at least once per year. Independent valuations are also required each time shares or units of an AIF are issued or redeemed.

Depository. An independent depository must receive and maintain investment subscriptions from AIF investors in a segregated account, safeguard financial instruments and verify ownership of all assets in which the AIF invests. A depository for a non-EU AIF must meet certain supervision, money laundering and liability standards at least as comprehensive as those of the European Union.

Conduct of business

Delegation. AIFMs cannot delegate tasks to third parties without meeting certain preconditions and obtaining authorisation for each such delegation.

Preferential treatment. AIFMs must ensure that all AIF investors are treated fairly. No investor is permitted to receive preferential treatment unless this preferred status has been disclosed in the AIF's constituent documents.

Conflicts of interest. AIFMs must take all reasonable steps to prevent any conflicts of interest that adversely affect the interests of the AIF and its investors. AIFMs must disclose potential conflicts between the AIFM (including its managers, employees and affiliates) and the AIF investors, as well as potential conflicts among AIF investors.

Risk management. AIFMs investing on behalf of an AIF must implement an appropriate due diligence process. AIFMs must also implement risk management systems and separate risk management and portfolio management operations.

Liquidity management. AIFMs must regularly conduct stress tests, monitor liquidity risks of AIFs and ensure that each AIF has an appropriate redemption policy.

Securitisation positions. AIFMs investing in securitised products on behalf of AIFs will have to meet qualitative requirements under measures that will be implemented by the European Commission at a later date.

Transparency and disclosure

Annual reports. AIFMs must publish annual reports including audited financial statements for each AIF they manage.

Pre-investment disclosure. AIFMs must ensure that investors receive prescribed disclosure on an AIF prior to investing including strategy, service providers, annual reports, liquidity risk and fees.

Periodic reporting. AIFMs must provide periodic reports regarding their trading and details on each AIF they manage including annual reports. AIFMs must also periodically disclose the AIF's risk profile and illiquid or difficult-to-value assets.

Highly leveraged AIFs. AIFMs are subject to increased disclosure requirements in connection with AIFs whose aggregate leverage exceeded equity capital in two of the prior four quarters. AIFMs must assess AIF leverage on a quarterly basis.

Controlling interest. AIFMs are subject to increased disclosure requirements when an AIF they manage acquires a total of 30 percent or more of the voting rights of a non-listed company that employs more than 250 people, has an annual turnover in excess of €50m or has an annual balance sheet total exceeding €43m.

Marketing

Authorised AIFMs can market only to professional investors in the Community, unless otherwise permitted by their home EU Member State. 'Professional investors' must meet enumerated criteria set forth in the proposed directive, but they are generally regulated financial market participants with sufficient experience and expertise to make their own investment decisions and weigh potential risks.

Authorised AIFMs can market AIFs to professional investors throughout the Community so long as they submit relevant disclosure materials to the 'competent authorities' of their home Member State. These materials include a notification letter, a prospectus and certain other prescribed information.

AIFMs can market non-EU-domiciled AIFs to professional investors domiciled in a Member State only if that country has an agreement with the Member State that is fully compliant with the Organisation for Economic Co-operation and Development(OECD) Model Tax Convention. ■

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