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C H A N C E

Client briefing
January 2011

AIFM Directive and Private Equity

On 11 November 2010, the European Parliament plenary approved the final text of the Directive on Alternative Investment Fund Managers (**AIFMD**). A copy is available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+20101111+SIT+DOC+PDF+V0//EN&language=EN.

The AIFMD will come into force twenty days after its publication in the Official Journal. Member States will have two years to enact the necessary laws and regulations to implement the AIFMD. The European Commission is also required to enact delegated measures to flesh out certain of the provisions of the AIFMD.

The AIFMD lays down the rules for the authorisation, ongoing operation and transparency of managers (each an **AIFM**) of alternative investment funds (ie a collective investment undertaking which is not a UCITS - each an **AIF**) and applies to any AIFM which:

- has its registered office in the EU;
- manages any AIF which is authorised or registered in, or has its registered office or head office in the EU; or
- markets any AIF in the EU.

One of the key points is that the AIFMD will apply to the marketing of any fund to investors in the European Union, even if the fund or the AIFM has no connection with the European Union.

This briefing considers the AIFMD primarily from the perspective of a private equity house (**PEH**) and is split into two sections. The first section considers the key issues which may affect the deal teams at a PEH and the second section considers regulatory issues which may affect the operations of a PEH.

ISSUES FOR DEAL TEAMS

Asset stripping

One of the most controversial provisions of the AIFMD that may directly affect deals is that where an AIF acquires control of an EU company, the AIFM must use its best efforts to prevent that company effecting distributions, capital reductions, share redemptions and/or the acquisition of own shares, in the first two years after the AIF acquires control, where:

- the net assets stated in the company's annual accounts for its last financial year are, or following the distribution or acquisition of own shares would become, lower than the company's subscribed capital plus those reserves which may not be distributed by law or the company's statutes; or
- the distribution would exceed the amount of the profits at the end of the last financial year plus any profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with law or the company's statutes.

If you would like to know more about the subjects covered in this publication or our services, please contact:

Nick O'Neill +44 (0)20 7006 1139

Simon Crown +44 (0)20 7006 2944

Anthony Stewart +44 (0)20 7006 8183

Alastair Woodland +44 (0)20 7006 8936

Thijs Alexander +44 (0)20 7006 4583

Amy Mahon +44 (0)20 7006 2111

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance LLP, 10 Upper Bank Street, London, E14 5JJ, UK
www.cliffordchance.com

While these two tests are similar to the requirements an EU public company has to satisfy, and the second test is similar to the requirements an EU private company has to satisfy, in order lawfully to make a distribution, this provision does have the potential to prevent a company from making a distribution when it could otherwise lawfully do so. This restriction also does not contain the useful carve out under which an English and certain other EU companies may be able to rely on interim accounts to justify the making of a distribution, if the most recent audited accounts do not permit the making of a dividend. The Commission does not, on the face of it, have the authority to grant exemptions to the general restrictions.

A PEH must carefully consider this restriction and discuss with its accounting and legal advisers the potential impact on its future plans, before acquiring any company in the EU which is likely to make disposals. Not only would this prevent asset stripping in the traditional sense, but it may fetter the ability to carry out legitimate reorganisations and refinancings or to divest part of the target business and pay the sale proceeds to the AIF by way of a dividend.

As the prohibition does not prevent payments to the AIF by way of a repayment of a loan, it should still be possible to take money out of a business through the repayment of shareholder debt, although this ability may be restricted where thin cap rules limit the amount of debt which can be put into a business. When structuring investments, it will be necessary to consider whether hybrid instruments in which an AIF invests, such as PECs, CPECs and SPCs, are to be treated as debt or equity for AIFMD purposes. In principle, if an instrument is categorised as debt in the company's accounts, it should be treated as debt for the purposes of the AIFMD.

Remuneration policies

The AIFMD is likely to have a significant impact on the way in which a PEH remunerates its senior staff. Member States' regulators will require AIFMs to put policies in place for certain categories of their staff that comply with the remuneration provisions in the AIFMD. The staff subject to the provisions will include senior management, employees receiving total remuneration which takes them into the same remuneration bracket as senior management who are material risk takers and control functions (**Covered Staff**).

Although nothing in the AIFMD limits how much Covered Staff are paid, the provisions on the calculation of remuneration and the way it is paid will be of concern to PEHs. (There are also provisions on how remuneration is overseen and monitored but these should not present too many issues in practice.)

Key issues for PEHs include the following:

- **Carried interest:** The provisions apply to any type of remuneration paid to Covered Staff and carried interest is included specifically. It is not at all clear how a PEH will demonstrate that the fixed v variable or deferral requirements (below) are met in relation to carry where carry is given a value of zero on grant.

- **Fixed v variable remuneration:** Fixed and variable remuneration need to be appropriately balanced. Fixed remuneration should be a high enough proportion of overall remuneration to allow the AIFM to operate a fully flexible variable remuneration policy, including the possibility of paying no variable remuneration. This does not sit comfortably with current PEH remuneration structures where a (relatively) low base salary may be paid but supplemented by variable carry. While carried interest is clearly within the definition of remuneration for the purpose of the AIFMD, it is still to be resolved whether various types of carry structures would constitute variable remuneration for the employees in question.

- **Deferral:** At least 40% of variable remuneration (60% in some cases) needs to be deferred. The deferral period depends on the particular AIF but at least 3 to 5 years is suggested.

- **Remuneration in units/shares:** At least 50% of variable remuneration is to be paid in units or shares of the AIF or equivalent ownership interests which must be subject to a retention policy. Some limited parts of PEHs are already subject to the FSA's Remuneration Code (Remuneration Code). What remains to be addressed is how a PEH which is currently required to comply with the Remuneration Code and which will

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also be required to comply with the AIFMD can reconcile the fact that the Remuneration Code refers to remunerating employees in the form of shares or equivalent ownership interests in the entity that is subject to the Remuneration Code and the fact that the AIFMD refers to remunerating staff through interests in a fund. The proportionality principle in the Remuneration Code may be helpful here.

- **Whole AIFM performance is what counts:** Variable remuneration should only be paid if justified by the financial performance of the AIFM as a whole. This could adversely impact a PEH's ability to pay out remuneration by reference to the performance of particular funds or investments.
- **No personal hedging:** Covered Staff should not use personal hedging strategies to offset the risks of their remuneration strategy.
- **Non-financial criteria count:** Financial and non-financial criteria should be taken in account when assessing performance.
- **Guarantees:** Multi-year guarantees will be outlawed.
- **Role of the FSA in the UK:** On 17 December 2010, the FSA published its revised Remuneration Code which applies to the remuneration of categories of staff within roughly 2,500 financial institutions covered by the Capital Requirements Directive III (known as "CRD III"). The FSA may view the Code as a blueprint when it comes to implementing the AIFMD, although the Code will have a very limited impact on PEHs directly. If this is the case, it will be interesting to see whether the implementation of the AIFMD remuneration provisions will follow the proportionality principle in the Remuneration Code with the effect that smaller firms may have scope to apply the rules less extensively.

Annual report

For each EU AIF (ie a fund whose registered office is in an EU Member State) which it manages and for each AIF which it markets in the European Union, an AIFM must prepare an annual report for each financial year, no later than six months following the end of the financial year. The report will be provided to investors on request and to the competent authorities.

Although many PEH already prepare annual reports in respect of their portfolio companies in accordance with the Guidelines for Disclosure and Transparency in Private Equity, the required content of the reports to be prepared under the AIFMD is more extensive. The reports must contain certain financial information, such as a balance sheet and income and expenditure account. The report must also contain details of material changes relating to the AIF, including its investment strategies, its net asset value or the market price of units or shares in the AIF and historical performance. More controversially, the report must outline the total remuneration for the financial year, split into fixed and variable remuneration, paid by the AIFM to its staff members, including details of carried interest.

Employee notification

When an AIF acquires, disposes of or holds shares in a non-listed company, its AIFM must notify the authorities in the home Member State of the AIFM of the proportion of the voting rights held by the AIF when that proportion reaches, exceeds or falls below 10 per cent, 20 per cent, 30 per cent, 50 per cent and 75 per cent.

When an AIF acquires control over a non-listed company, its AIFM must notify the company, its other shareholders and the authorities in the home Member State of the AIFM. In the notification to the company, the AIFM must request the board of directors to inform the employees, without undue delay, of the acquisition of control by the AIF. The AIFM must also inform the company and its shareholders of its intentions with regard to the future business of the company and the likely repercussions on employment, including any material change in the conditions of employment, and request the directors to make this information available to the employees.

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REGULATORY ISSUES WHICH HAVE IMPLICATIONS FOR OPERATIONS

Scope of application

As noted above, the AIFMD applies, amongst other things, to any AIFM which markets an AIF in the European Union. For the purposes of the AIFMD, marketing involves the direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares in an AIF it manages to or with investors domiciled in the European Union. As the definition does not require the AIFM to have any presence or even to carry out any activities within the European Union, any AIFM outside the European Union should be aware of the AIFMD as it will apply to it to the extent that AIFs which it manages are marketed to potential investors in the European Union.

In the context of private equity AIFs, it is generally expected that the AIFM would be the general partner of the relevant fund. However, some have raised questions over whether this would be the case in all circumstances and therefore it would be useful to obtain clarity that this would indeed be the case.

The AIFMD does not apply to employee participation schemes or to national, regional and local governments and bodies or other institutions which manage funds supporting social security and pension systems.

Authorisation

The consequence for an AIFM of being subject to the AIFMD is that the AIFM must obtain authorisation from the competent authorities in its home EU Member State (or, where the AIFM is not based in the EU, it must obtain authorisation from the competent authorities in an EU Member State of its choice). In order to be granted authorisation, an AIFM must comply with various requirements, including capital requirements and the requirement to have a depository, as set out below. Once granted, such authorisation will be valid for all Member States. An existing AIFM must submit an application for authorisation within one year of the deadline for implementing the AIFMD.

An exemption to requiring authorisation applies where an AIFM manages portfolios of AIFs whose assets under management do not exceed (i) 100 million euros, or (ii) 500 million euros if the AIFs are not leveraged and have no redemption rights during a period of 5 years following the date of the initial investment in the AIF, although such an AIFM will still be subject to a registration (as opposed to an authorisation) requirement in its home Member State. However, such AIFMs do not benefit from any of the rights under the AIFMD, such as the passporting rights set out below, unless the AIFM chooses to opt in to the provisions of the AIFMD.

For the purposes of the AIFMD, an entity will be an AIFM if it provides investment management services referred to in paragraphs 1(a) or (b) of Annex I to the AIFMD to one or more AIF, ie portfolio management or "risk management" (undefined) services, respectively. In the common PEH structure of an off-shore manager and an on-shore adviser, it is possible that not only will the off-shore manager be caught (as it will be providing portfolio management services), but the on-shore adviser may also fall within the definition of an AIFM, if it carries out risk management services to an AIF. The classification of an advisory entity as a manager under AIFMD may have unhelpful implications for the tax structure of the PEH. This is a key issue for PEHs with off-shore manager/on-shore adviser structures to monitor as the AIFMD is implemented and supplementary legislation is developed by the Commission.

Furthermore, an AIFM must not engage in activities other than those referred to in Annex I of the AIFMD. Annex I specifies a wide range of activities relating to the management of an AIF. Where an AIFM is a division of a bank, for example, the relevant legal entity is likely to carry out activities other than those specified in Annex I. In such cases, the bank may need to move its AIFM business into a separate company.

More robust risk management

The AIFMD seeks to reflect some of the lessons learned from Madoff and Lehman in the more robust risk management processes which it will require AIFM to put in place. The AIFMD will impose obligations in respect of the management of conflicts of interest, the management of liquidity risk, valuation of the fund and delegation by the AIFM of any of its functions.

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Passports

EU AIFM managing EU AIF will have rights to market the fund to professional investors throughout the EU. This passporting regime will become available as soon as the AIFMD is implemented by Member States in 2013.

The AIFMD also contains passporting provisions, allowing the marketing in the European Union of a non-EU AIF managed by an EU AIFM, an EU AIF managed by a non-EU AIFM or a non-EU AIF managed by a non-EU AIFM. In such cases, it is necessary for several conditions to be met, such as appropriate cooperation arrangements to be in place between the authorities of the relevant European Member State and the third country involved. It remains to be seen which third countries' authorities are deemed to have appropriate cooperation arrangements in place or what will be considered to be appropriate cooperation arrangements. These passporting rights will only become available at the earliest in 2015, if the European Securities and Markets Authority (ESMA) issues a recommendation to the Commission that the rights should be made available. Before such rights become available, marketing will need to be conducted within the scope of existing private placement rules in each relevant Member State. It is anticipated that such rules will be switched off in 2018 if passporting becomes mandatory. However, even if a Member State's private placement rules remain in place until 2018, there is no guarantee that the rules will be stable or continue in their current form. Passporting rights are only available to entities which are AIFM and which comply with the requirements of the AIFMD.

Capital Requirements

As a condition to being granted authorisation, an AIFM must have initial capital of 300,000 euros where the AIFM is an internal manager of an AIF, eg the general partner of an AIF, and 125,000 euros where the AIFM is an external manager of an AIF. Where the value of the portfolios managed by the AIFM exceeds 250 million euros, the AIFM must have additional own funds of an amount equal to 0.02 per cent of the amount by which the value of the portfolios exceeds 250 million euros (subject to a maximum total capital requirement of 10 million euros).

To cover professional liability risks, the AIFM must either have additional own funds which are appropriate to cover potential liability risks arising from professional negligence or appropriate professional indemnity insurance.

Depositories

For each AIF which it manages, an AIFM must ensure that a single depositary is appointed. The depository must either be a credit institution with its registered office in the European Union or an investment firm with its registered office in the European Union or another institution which is subject to prudential regulation and ongoing supervision.

A non-EU AIF may appoint as the depository a credit institution or investment firm with a registered office outside the European Union, provided it is subject to effective prudential regulation and supervision of the same effect as the provisions laid down in European Union law, which are effectively enforced.

Where investors in the AIF have no redemption rights during the period of five years from the date of the initial investment and the AIF generally invests in issuers or non-listed companies in order potentially to acquire control, eg private equity funds, the depository may be an entity which carries out depository functions as part of its professional or business activities in respect of which it is subject to mandatory professional registration recognised by law or rules of professional conduct and which have sufficient financial and professional guarantees to be able to perform those depository functions. Although this definition is rather vague, the recitals to the AIFMD suggest that this should permit a notary, lawyer or registrar to carry out depository functions.

The role of the depository includes ensuring the AIF's cash flows are properly monitored, that all payments made by or on behalf of investors upon the subscription of shares or units in the AIF have been received and verifying the ownership, and maintaining a record, of the assets of the AIF. During the development of the AIFMD, there has been significant debate over the levels of liability that would be imposed upon depositories.

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Questions

We would be very happy to discuss with you any questions or concerns which you have in relation to the issues in this briefing.

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