WEIL GOTSHAL

Private Equity Alert

Special Edition
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Update on EU Proposal To Regulate Private Equity Fund Managers

By Elaine O'Donnell (elaine.odonnell@weil.com), James Harvey (james.harvey@weil.com) and Oliver Williams (oliver.williams@weil.com)

In April 2009, the European Commission published a draft directive on the regulation of alternative investment fund managers as part of its program to extend appropriate regulation to all "actors and activities that embed significant risk" following the recent financial crisis.

The directive is intended to create a harmonized, comprehensive and effective framework for the authorization and supervision of alternative investment fund managers established in the European Union ("EU") who are not already covered by existing EU legislation and therefore covers, among others, hedge fund and private equity fund managers. It also seeks to apply to fund managers established outside the EU when marketing funds within the EU.

The explanatory memorandum to the directive notes that private equity funds did not contribute to increased macro-prudential risks during the financial crisis. However, to ensure a fully effective regulatory solution, a *common set of provisions will apply to all those fund managers caught within the scope of the directive*. Hedge funds and private equity funds will therefore be subject to the same provisions. This 'one size fits all approach' has met with a generally hostile reception from the private equity community.

Since publication of the draft directive by the European Commission (the main executive body of the EU), draft proposals have been published by both EU legislative bodies (the Council of the European Union ("Council") and European Parliament ("Parliament")). Council and Parliament must jointly agree on and adopt legislation based on a proposal by the European Commission. Both the Council and Parliament have yet to reach agreement internally on the main issues raised by the directive.

This article highlights potential key issues for the private equity industry following publication of Council's proposal of March 10, 2010 and the responses of the Committee on Economic and Monetary Affairs to Parliament of February 12, 2010. The level of divergence of views expressed by member states and members of Parliament on the main issues makes it difficult to predict the outcome of the proposals.

Who Does the Proposed Directive Apply To?

EU investment fund managers

An EU investment fund manager must be authorized and regulated by its EU home member state regulator.

To a certain extent, in some EU member states this will not be a significant departure from current practice. In the UK, for example, private equity firms must already be authorized by the Financial Services Authority which sets out rules and procedures governing their management.

Following authorization, EU investment managers will be entitled to market EU funds to professional investors and provide management services in any EU member state, in each case subject to a notification procedure.

The initial draft directive only applied to EU fund managers managing EU funds or marketing funds within the EU (provided the funds exceeded certain fairly minimal thresholds). Recent proposals have widened the directive's scope and, if adopted as currently drafted, would require EU fund managers, managing funds which are *neither established nor marketed in the EU,* to comply with the majority of the directive's provisions. There would also need to be cooperation arrangements currently unspecified in place between the fund manager's home member state and the supervisory authority of the third country where the fund is established.

The minimal thresholds originally proposed, below which EU investment fund managers would not be subject to the directive, may become optional on a state-by-state basis. Fund managers of those member states taking advantage of the exemptions would not be able to benefit from the EU 'passport' but would still be subject to certain registration and notification provisions. This would prevent them from managing and marketing funds in other member states unless they opted back in to the full directive.

The "one size fits all" approach has met with a generally hostile reception from the private equity community.

Non-EU investment fund managers

A significant area of divergence of opinion surrounds the position that should be taken regarding the marketing, within the EU, of funds by non-EU fund managers.

The initial draft of the directive permitted non-EU fund managers to become 'authorized' under the directive and thereby become eligible to market funds across the EU provided they complied with certain conditions, including that they were subject to home country legislation equivalent to the directive. Subsequent drafts from both the Council and Parliament have removed the concept of non-EU investment fund managers having an EU 'passport'. Council's current draft requires application by a non-EU fund manager to each individual member state to become eligible to market funds in that particular member state. Member states would only be able to grant authorization if there were appropriate cooperation arrangements between the fund's home country regulator and the relevant member state for the purpose of systemic risk oversight and the fund manager complied with certain of the provisions of the directive on transparency and disclosure (detail below).

How Will the Directive Affect Private Equity Funds within the Scope of the Directive?

EU investment fund managers

Imposition of remuneration policies

Since initial publication of the directive, Council has proposed that fund managers be required to adopt certain remuneration policies and practices including the requirement to defer at least 40% of the variable remuneration of staff who have a material impact on the risk profiles of managed funds. The imposition of the remuneration policy is suggested by the European Venture Capital Association to be a "virtual cut-and-paste of G20 rules relating to staff at banks".

Maintain increased capital

Fund managers are likely to be required to maintain minimum capital. The amount of capital required will be at least €125,000. Where assets under management are over €250 million, additional capital equal to 0.02% of the amount by which the value of the assets exceeds €250 million is required subject to a proposed cap of €10 million.

Disclosure at portfolio company level

EU companies (within certain parameters) defined as being under the 'control' of private equity funds will be required to disclose additional information. This has led to concerns that the directive would result in an uneven playing field between companies owned by funds subject to the directive and those that are not.

There is a divergence of opinion on the level of ownership determining whether a controlling influence has been achieved. The original directive proposed 30%, while suggestions since have varied from as low as 10% to as high as 50% (with Council's latest proposal advocating 50%).

Recent proposals have suggested a requirement for disclosure of leverage at the portfolio company level directly before and after control has been reached and whenever material changes occur. Members of Parliament have also tabled amendments to include the prevention of asset stripping, limiting (not just disclosing) leverage at the portfolio company level and prescribed lock-in periods for investment.

Valuation

All fund managers will be required to ensure appropriate procedures are established so that there is a proper valuation of the fund's assets at least annually.

Parliament's initial report recognized that valuation was inappropriate for private equity funds however wording to that effect has not been reflected in recent proposals. Following the tabling of proposed amendments to Parliament it would appear there is at least some consensus that valuation requirements should be proportionate in frequency and application.

Depositary

The directive proposes the appointment of an independent custodian (e.g., an EU credit institution) to, among other things, verify title to assets and receive investor subscriptions in a fund and book them into a separate account. Council suggests that the depositary also be responsible for ensuring the manager establishes and complies with appropriate valuation procedures. As well as noting the inappropriateness of a depositary when private equity funds do not have redemption rights, concerns have also been raised about the concentration of risk in EU credit institutions, provisions on liability leading to difficulties in retaining depositaries and the difficulties in some circumstances of requiring assets to be held in the EU.

Non-EU investment fund managers

The original draft, as mentioned above, envisaged non-EU fund managers would only be authorized to provide services in the EU if they were subject to provisions equivalent to the directive. Council's latest proposals water this down and non-EU fund managers would only be required to comply with provisions requiring:

- production of an annual report;
- prescribed disclosures to investors;
- reporting to competent authorities; and
- disclosures when 'control' is reached at portfolio company level (described above in more detail).

Cost

The ambitions of the directive will not be without cost to the alternative investment fund industry. The cost to European private equity funds alone, of implementing the directive, is estimated to be €756 million in one-off charges and €248 million in annualized costs according to a report commissioned by the UK's Financial Services Authority.

Market reaction

Although the industry recognizes a directive as now inevitable, it considers the directive goes too far in its reach. The most vociferous opposition to the directive has come, unsurprisingly from the UK (the centre of the EU alternative investment industry) with significant pressure on the UK government to take a strong stance against the directive. Certain EU commissioners and political party leaders however continue to believe the proposals are too lenient.

What Next?

The Spanish Presidency, on behalf of the Council, is hoping to reach agreement on its revised proposals among EU Member state governments before handing over the presidency to Belgium in June, having recently agreed not to put the directive to a vote before mid May.

Parliament's revised proposal is being debated over the next few weeks. A vote is scheduled for April 12, 2010 when it is intended that Parliament arrive at a single position (an unenviable task given approximately 2,000 amendments that were recently tabled).

Once Council and Parliament agree on a directive, it is expected that member states will be given two years to implement the directive.

We will be monitoring and updating you on the progress of the proposed directive, and the political and industry discussions that it will no doubt stimulate over the coming months.

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