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THE AIFMD AND PRIVATE EQUITY

DR LARAGH CASSAR, OF CAMILLERI PREZIOSI, OUTLINES THE POSITIVE AND NEGATIVE ASPECTS OF THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE ON MALTESE PRIVATE EQUITY FIRMS



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The Alternative Investment Fund Managers Directive (AIFMD) has long been criticised, debated and negotiated by the private equity industry. The final drafts of the AIFMD and level II measures have been welcomed by the industry. While, in principle, private equity firms continue to have their misgivings about its necessity, they appear to acknowledge that some of their concerns have been taken on board. Although the AIFMD is not intended to regulate the alternative investment funds (AIFs) themselves, the regulation of the manager and other service providers has a direct effect on the manner in which private equity firms shall operate under this regime.

DISCLOSURE

The AIFMD will bring with it substantial changes to the manner and level of disclosures that are to be made by managers of private equity firms. The AIFMD imposes disclosures on investment types, concentrations, valuations, risk management and stress tests. A manager is also required to report the financing of an acquisition of control of entities, derivative positions and the reuse of assets in the AIF's annual report. The directive, however, exempts notification for AIFMs which could be placed in a vulnerable position vis-à-vis its competitors and the level II measures seem to have reduced the remit of such disclosures.

ASSET STRIPPING

Private equity firms' ability to maximise their return on investment and improve shareholders' return on capital invested in the firm has been restricted by virtue of the asset stripping provisions. Pursuant to these provisions, restrictions are placed on AIFs to pay dividends, carry out share buy-backs or conduct other transactions that are deemed to weaken the capital bases of 'controlled' portfolio com-

panies (SMEs are exempt) during the first two years of ownership by an AIF. This restriction is also likely to place private equity funds at a disadvantage to competitors, such as high-net-worth individuals, that are regulated under the AIFMD.

DE MINIMIS

The *de minimis* provisions have alleviated some concerns previously raised by private equity firms in that closed-ended funds that do not employ leverage are exempted from the requirements of the directive. The key to this

matter, however, is in the definition of leverage which according to the directive is defined as being any method by which the manager increases the exposure at the level of the AIF it manages. The level II regulations make reference to the AIFMD definition but also reiterate that in the case of an AIF whose core investment policy is to acquire control of non-listed companies, the leverage of the non-listed entity should not be calculated in determining the leverage of the AIF. Temporary borrowings which are covered by capital commitments from investors are also excluded from the AIF's leverage calculation.

Another element of the AIFMD text which was heavily debated relates to the imposition of a depositary for all AIFs and the substantial increase of their obligations and risk exposure. The private equity industry was not silent in this respect and its objections have resulted in the exemption afforded by the directive which permits member states to allow notaries, lawyers and other entities to be appointed as depositaries for private equity firms and other funds that do not allow investors to make redemptions for a minimum period of five years and whose core investment policy is generally not to invest in assets that must be held in custody or generally invest in issuers of non-listed companies to acquire control.

“PRIVATE EQUITY FIRMS' ABILITY TO MAXIMISE THEIR RETURN ON INVESTMENT AND IMPROVE SHAREHOLDERS' RETURN ON CAPITAL INVESTED IN THE FIRM HAS BEEN RESTRICTED BY VIRTUE OF THE ASSET STRIPPING PROVISIONS”



AIFMD BENEFITS TO THE INDUSTRY

The AIFMD does not wholly negatively impact the private equity industry. Indeed, the added regulation on the managers' own funds, remuneration policies and practices of managers should be interpreted as promoting and enhancing transparency and sound risk management rather than curtailing the industry's established practice. The remuneration policies must be structured in such a way as to ensure continued sound and effective risk management and avoidance of conflicts of interest. Senior management, and others that occupy a control function or persons whose professional activity has a material impact on the risk profile of the AIF they manage, are also caught within the requirement. The Directive also reserves some options for the disclosure of fixed and variable remuneration (which is typical of fund managers). However the general rule is that these disclosures are to be made in the AIF's annual report.

A manager's capital is subject to a minimum of €300,000 for self-managed funds and €125,000 for external managers, which increases in relation to the amount of assets under management. In addition, AIFM will also be afforded a pan-European passport for its fund management services. This will afford greater flexibility for the managers in terms of access to AIFs, structuring and marketing possibilities. The directive allows managers to market their funds to professional investors across the EU through a notification procedure directed through the home regulator. The authorisation is required to take place within 20 days (unless the manager is not fully compliant with the Directive).

In addition, the directive also regulates the risk management and investment management functions to be performed by the AIFM. The manager will be subject to increased obligations on the management of conflicts

of interest, liquidity risk, valuations and delegation of its functions. The manager is also required to, when acquiring control over a non-listed company, notify the company, its other shareholders and the manager's home regulator. The manager must also request the board of directors to inform its employees of the acquisition of control by the AIF and 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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AIF MANAGERS WILL BE AFFORDED A PAN-EUROPEAN PASSPORT FOR ITS FUND MANAGEMENT SERVICES.

THIS WILL AFFORD GREATER FLEXIBILITY

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The AIFMD can definitely be said to have impacted the private equity industry. Having said that, the extent and cost of this impact is yet to be determined with any level of certainty. The voice of the private equity industry on the draft regulatory framework has, in some instances, left its footprint and has filtered through the final draft of the directive and implementing measures. As it currently stands, the private equity industry appears to have embraced the framework with a lot more positivity than that which was previously evidenced. ■