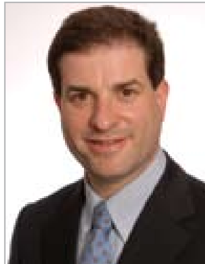
unquote”

Ram-shackled

Following the hostile response to the EU Commission's proposed Alternative Investment Fund Managers Directive by private equity trade bodies, unquote” invited five prominent lawyers to share their views on the impact the new legislation could have on the industry. Similarly to practitioners, it seems concerns over the scope of the regulations dominates opinion

The devil is in the detail

Adam Levin, Dechert LLP


Adam Levin

The fact that the draft directive was only published a day after the FAQs became available meant that media comment at the time was limited to the summary information provided in the FAQs. At first blush, these give a rather rosy picture of the proposals and, in particular, note that there is “no obvious regulatory need for regulating investment policies directly or for requiring the registration of funds”. One of the given reasons for this was that it might introduce “moral hazard”, as investors “may perceive that regulators exercise greater direct control over the fund than is in fact the case”. Perhaps this is code for the concern that regulators may then have greater liability if funds invest poorly.

However, when the small print of the proposed Directive was published it became clear that there is quite a lot of regulation which may directly affect the investment policies of a fund.

For example, requirements relating to the disclosure of information where the fund acquires 30% or more of the voting rights of certain companies, such as the development plan (an undefined term) for the company and its policy for communication “as regards employees” (a phrase similarly susceptible to wide interpretation). This must be disclosed to the relevant company, its shareholders and representatives of the employees.

Why would a private equity fund manager subject itself to that level of scrutiny with only 30% voting control? What if two fund managers have more than 30% voting control and have inconsistent policies? Will club deals avoid the need for disclosure if no manager holds 30% of the voting rights?

So, be careful of the devil in the detail – it may have unintended consequences.

Counting the cost

Tim Dolan, Pinsent Masons

Tim Dolan

The draft directive is a highly prescriptive compromise that has failed to satisfy any one industry or political group. Even the Party of European Socialists are not happy with it, claiming that it has “more holes than Swiss cheese”. From a private equity perspective, the reality is that many of the proposals are unnecessary and place an increased burden on fund managers for no reason.

Indeed, while the Commission has commented that private equity does “not contribute to increase macro-prudential risks”, the only clear concession is to include a higher total funds under management de mininis carve out of €500m (against €100m), where funds managed are neither leveraged nor capable of granting redemptions in the first five years. The BVCA suggests that approximately 70 private equity houses and their portfolio companies will be subject to the new regime.

The real concern is the imposition of additional unnecessary cost for private equity managers and, ultimately, their funds and investors. Costs will arise through requirements for the publication of annual reports; appointment of independent valuers; reporting to home state regulators; and obligations on portfolio companies to provide prescribed information to their fund managers.

On the other hand, one feature of the draft directive which could be of use is the ability for fund managers to distribute funds to professional investors throughout the EEA. This may counteract current problems with local law compliance when marketing funds across in Europe.

It is likely that the directive will not proceed quickly and will be amended during consultation. It is therefore important for the UK private equity industry to ensure that its views are heard during the Council Working Groups, which are set to commence in the next month.

One size doesn't fit all

**Markus Schackmann and Angelika Yates,
Luther Rechtsanwaltsgesellschaft mbH**

The reaction of the European private equity and venture capital community to the proposed EU Commission Directive is best illustrated by the words of EVCA Chairman Jonathan Russell: "The Commission's proposals hit the wrong people, at the wrong time, in the wrong way."

One of the major concerns is that the proposed thresholds have been set too low and thereby impose quite complex burdens in relation to valuation, risk, liquidity management and capital reserve requirements on managers of "mid-market" funds, effectively increasing the cost of investment for end-investors. Furthermore, the proposed ongoing disclosure and transparency requirements are quite onerous and in some cases may even exceed those obligations placed on listed companies, potentially disadvantaging PE invested companies against competitors using other means of finance.

It is also likely that banks providing loans to PE investments will ask for access to the same level of information as is available to the investors and the supervisory authority, which may impact on the underlying loan documentation (e.g. additional covenants).

Markus Schackmann

Angelika Yates

The PE industry will be further impacted by certain disclosure and notification requirements that will apply if the fund acquires a controlling interest (i.e. more than 30% of the voting rights) in a non-listed company, which could prompt investments to be kept just below this threshold. Moreover, under the proposals PE invested companies that are delisted will continue to be subject to ongoing reporting obligations for listed companies for two years, a fact that could result in fewer take-privates.

The general concept of having a EU-wide harmonised regulatory framework bears certain advantages and, in particular, facilitates cross-border PE investments on a level playing field. However, some of the proposed measures could impose a disproportionate burden on private equity funds and their portfolio businesses, and ideally the directive should differentiate more between different asset classes to mitigate this risk.

Regulatory risk

Mark Spinner, Eversheds

Regulators have a dual responsibility: preventing systemic risk to the economy whilst maintaining an environment conducive to growth. It has been widely argued that during the last economic cycle regulators focused too much on stimulating growth and not nearly enough on managing risk. Conversely, the present danger is that regulators are lunging recklessly in the opposite direction, focusing so much on preventing risk that they will unduly constrain enterprise.

Mark Spinner

The draft regulations are ostensibly directed at entities capable of posing systemic risk such that their failure would be likely to affect the stability of financial markets. However, the extremely low thresholds proposed means that the vast majority of funds caught by the directive do not pose any genuine threat to the stability of financial markets.

Affected managers will be required to appoint an independent valuer to value units/shares in their funds and any assets in which such funds are invested. There are also detailed disclosure requirements in respect of any holding of 30% or more of the voting rights of an issuer or private entity that employs more than 250 people and has an annual turnover of more than £50m and/or a balance sheet of more than £43m. As such, these regulations are likely to impact on a significant number of entities, imposing an estimated compliance burden of £30-40,000 per annum.

Private equity provides desperately needed risk capital in a stalled, increasingly risk averse market. The asset class is almost exclusively comprised of sophisticated investors who understand the associated risks and it has coped very well via self regulation for over 50 years. It would be a backward step in a free market economy if regulators, in seeking to address risk, suffocate the performance of this important industry.