The AIFM doesn't affect deal doing. It is just a back office issue.

Life is never quite that simple. This article identifies four ways in which the Alternative Investment Fund Managers Directive (AIFMD) could affect private equity executives in executing transactions once it comes into force. In the UK, the deadline for AIFMD compliance is 22 July 2014.

Watch out for "leverage"
You can avoid having to worry about almost all of the AIFMD if:

- your AuM is below €500m;
- your funds are closed ended (as a standard PE fund will be);
- your funds have no redemption rights within five years (which there will not be in a standard PE fund); and
- your funds are "unleveraged".

You can also exclude from your AuM any funds which are not making additional investments after 22 July 2013 or whose life expires after 22 July 2016.

If you do introduce AuM acquired through "leverage" into your fund, you cannot rely on the above exemption. Instead, you have to have AuM of under €100m (including assets acquired through leverage) to be exempt. This means that, if a PE fund introduces leverage to acquire just £1 of AuM, this could have a draconian consequence for the relevant PE manager if it would otherwise have had AuM of less than €500m but more than €100m.

So what is "leverage"? "Leverage" for these purposes is any (generally temporary) method by which the manager increases the exposure of a fund it manages whether through the borrowing of cash or securities, or leverage embedded in derivative positions or by any other means.

Still no clearer? This definition is aimed more at hedge funds than PE funds and it does not capture leverage introduced at below the fund level so normal bidco acquisition finance should not be an issue, which is obviously good news.

If you are exposing the PE fund itself to any sort of direct commitment or potential liability though, you should be very careful.

An equity commitment letter from the fund, provided it is capped at the amount of undrawn commitments and will be satisfied by drawdowns from LPs in line with their then current commitments, should be fine.

A bridge facility in respect of LP draw downs should also be fine, provided the bank's recourse is limited to those undrawn LP commitments so, on default, the bank debt would be repaid by enforcing against those commitments and the fund would be in the same net position.

However, any fund level liability which is not simply backed by undrawn capital is likely to be leverage and the cautious view is that guarantees by a fund of a portfolio company's obligations could be leverage in certain circumstances. In each case, this could tip the fund into having to be fully AIFMD compliant, when it really did not have to be.

Need for depositaries
If you are a fund which is subject to the AIFMD, and therefore an Alternative Investment Fund (an AIF), you are going to have to appoint a depositary.

One of the jobs of a depositary is to act as custodian of assets. A depositary has strict liability for the assets it holds in custody and therefore will be liable for their value if they are misappropriated and extremely risk averse in dealing with them.

The good news is that unlisted shares and loan notes/other debt instruments which are not cleared through a clearing and settlement system are not custody assets for which depositaries are strictly liable. So, in a typical private company LBO, there would not be a need to involve the depositary in holding the assets.

However:

- custody assets do include listed shares so, if a portfolio company undertakes an IPO with the AIF retaining shares following the listing, a depositary will need to be involved and the interaction between the relevant CREST nominee (for example) and the depositary will need to be worked through;
- even for non-custody assets such as unlisted shares, the depositary will still have to verify a fund's ownership and this includes an obligation to look through underlying holding structures and vehicles; and
- a depositary has a general "oversight" function which includes monitoring compliance with a fund's investment policy (including, for example, diversification limits).

In any event, particularly in the early stages of learning to live with AIFMD, managers of AIFs should ensure that their depositary is given as much notice as possible that a deal is likely and what it involves in order to avoid the risk of a material delay in the execution phase. Most PE depositaries will expect some involvement prior to completion of a deal.

Asset stripping and the restriction on dividend recaps
If a manager of an AIF (or, in this case, a non-EU AIF marketed in the EU) acquires control of a non-listed EU company, for a period of 24 months following the acquisition it cannot facilitate or support any dividends, capital reduction, share redemption or share buy-backs which:

- reduce the net assets of the company below its subscribed capital plus its non-distributable reserves; or
- exceed the amount of the company's cumulative realised profits plus other distributable reserves, less the aggregate of any cumulative losses and other non-distributable reserves.

At a time when dividend recaps are an increasingly viable and popular option for PE managers, this could clearly be problematic if they are prohibited during the first two years of a buy-out (and non-AIFs are not so restricted).

There may well be a solution. Shareholder debt is not caught by these provisions so, provided the dividend recap is structured so that the return of cash to the fund is through a repayment of shareholder debt, the asset stripping provisions do not apply.

The asset stripping rules also don't apply to (a) SMEs (companies (i) with fewer than 250 people and (ii) which have a turnover of less than €50m or net assets not exceeding €43m) and (b) SPVs established to hold real estate.

Disclosure of voting rights
The AIFMD has also introduced some new notification provisions for AIFs (including non-EU AIFs marketed in the EU for these purposes). If you, the AIF, acquire (directly or indirectly) more than 50 per cent of the voting rights ("control") in a non-listed EU company:

- you now have to notify the regulator (the FCA in the UK) of the voting rights held by the AIF any time it reaches, exceeds or falls below the percentage thresholds of 10 per cent, 20 per cent, 30 per cent, 50 per cent and 75 per cent; and
- you have to provide the regulator and your fund investors with information on the financing of the acquisition.

These are additional procedural steps which need to be dealt with but which do not directly affect transactions.

More significantly, if your AIF is acquiring control of a non-listed company, you now have to disclose to the company, its shareholders and the regulator:

- the identity of the AIF manager (AIFM);
- the policy for managing conflicts between the AIFM and the company;
- the specific safeguards which ensure that any agreements between the AIFM and the company are concluded at arm's length;
- the policy for external/internal communications relating to the company and particularly as regards employees; and
- the AIF's intentions as to the future business of the company and the likely repercussions on employment, including any material change in employment conditions.

You also have to request that the board of the company passes on this information to employees without undue delay and use your best efforts to ensure that the board complies with this request.

As a minimum, your investment agreement with your portfolio companies should therefore:

- include a conflicts policy;
- include a requirement for all arrangements between the AIF and the company to be concluded at arm's length (and it will be interesting to see how practice develops in relation to any objective justification being provided by PE managers for their level of transaction or monitoring fees); and
- ensure that that the portfolio company undertakes to pass on the notification to employees (and AIFs are likely to want some controls around the conduct of any employee discussions which result from that).

You will also be required to include in your annual report likely future developments for the company and this will again be made available to employees.

There are exceptions to some of these rules where providing the information would seriously harm the functioning of the company or would be seriously prejudicial to its directors and, again, they do not apply to SMEs.

Next steps

Particularly during the initial AIFMD familiarisation period, deal executives will need to work closely with the rest of their firm and external counsel to ensure that the novel issues thrown up by the AIFMD are properly dealt with.

PE managers caught by the AIFMD should now be putting in place reporting procedures and deal questionnaires to ensure that the AIFMD is appropriately dealt with in a deal doing context and focusing on the issues identified above.

Contact details

If you would like further information or specific advice please contact:

Luke Powell
Partner
Real estate
DD +44 (0)20 7849 2658
luke.powell@macfarlanes.com

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