KAYE SCHOLER LLP

INVESTMENT FUNDS NEWSLETTER

Understanding the Partnership Agreement of an SBIC Fund

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The allures of Small Business Investment Company ("SBIC") funds are easy to understand. They include leveraged financing guaranteed by the Small Business Administration ("SBA") of up to three times the amount of private capital raised by an SBIC fund (currently subject to a cap of $150 million) and low interest rates. This results in potentially larger returns for investors and larger management fees for fund managers.

The SBIC license process and the SBA's rights with respect to an SBIC fund can be more difficult to understand for first-time SBIC investors, general partners and fund managers. Since most SBIC funds are limited partnerships, questions often arise when these parties negotiate the fund's partnership agreement. This article provides a brief overview of the SBA Model Form of Agreement of Limited Partnership (the "Model Agreement")[1] and highlights common investor concerns when negotiating an SBIC fund's partnership agreement. We also analyze how the Model Agreement addresses those concerns and, where available, offer suggested amendments to the Model Agreement that have been previously accepted by the SBA.

The Model Agreement

The SBIC licensure process includes a review of a fund's governance documents by the SBA. Accordingly, the SBA provides the Model Agreement to applicants to help streamline the review process. The majority of the Model Agreement is presented in bold font, which indicates that such language is mandated by the SBA and cannot be deleted. The remainder of the document is presented in regular font, and generally can be modified as long as the changes do not adversely affect the SBA's rights under the partnership agreement and do not conflict with the SBA's standard policies and procedures. Although applicants are not required to use the Model Agreement as precedent, all provisions in bold font in the Model Agreement must be included in the fund's partnership agreement. Moreover, each applicant is required to submit a copy of its partnership agreement, together with a redline marked against the Model Agreement, to the SBA as part of its SBIC license application. For these reasons, very few applicants elect not to use the Model Agreement as precedent.

The impatient applicant should be warned, however, that using the Model Agreement will not expedite the SBIC license process. On average, the SBA takes about four to six months to review each SBIC license application. The SBA's review can be further delayed if there are heavy revisions to the Model Agreement, or if the applicant does not use the Model Agreement.

Common Investor Concerns About the Model Agreement

Many first-time investors in SBIC funds have concerns about the Model Agreement. The following is a list of the most common concerns, together with an analysis of how

[1] A copy of the Model Agreement can be found at: http://www.sba.gov/idc/groups/public/documents/sba_program_office/inv_modeldebenture.pdf

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they are treated under the Model Agreement and, where available, proposed resolutions to accommodate investors.

No-fault termination of the Fund. Investors regularly request the right to terminate the fund upon the affirmative vote of the limited partners. The Model Agreement does not permit such unilateral termination unless the following factors are satisfied: (a) the election to dissolve the fund is at least ten years after the fund's formation; and (b) all leveraged financing and all other amounts owed to the SBA and its affiliates are repaid.

To understand the justification for these factors, it is important to understand that an SBIC fund obtains leverage by issuing debentures that are guaranteed by the SBA and then sold to investors in public markets. The debentures, which have ten-year terms, are interest only until their maturity, at which time all principal is due. The debentures can be prepaid in whole or in part without penalty, but only on semi-annual interest payment dates or other dates approved by the SBA. Since the general partner of the fund determines whether its debentures will be repaid in whole before their maturity dates, limited partners effectively lose the power to dissolve the fund until the debentures have matured.

Investors should also keep in mind that the SBA makes by far the largest investment in each SBIC fund. In most cases, the SBA's investment is at least twice the size of the investment of all of the limited partners combined, although the SBA's investment can be up to three times larger than the investment of all of the limited partners combined. To protect the SBA's substantial investment, the Model Agreement includes several mandatory provisions that require that the leverage and fees owed to the SBA be repaid before the limited partners get certain rights or distributions. One example of such a provision is the SBA's priority position in the event that the fund is dissolved and liquidated.

To mitigate limited partners' concerns, however, the Model Agreement provides that the fund can be dissolved (a) if its general partner withdraws, (b) on the later of (i) a certain date, which must be at least ten years after the fund's formation and (ii) two years after the debentures have matured, or (c) upon an affirmative vote of the limited partners (provided such vote occurs at least ten years after the fund's formation and all amounts owed to the SBA have been repaid). In addition, the Model Agreement provides five scenarios in which a limited partner may withdraw from a fund if such limited partner obtains a legal opinion stating that, as a result of the limited partner's entity status (*e.g.*, such limited partner is an employment benefit plan, government plan, a tax exempt entity or an investment company), such limited partner must withdraw from such fund in order to avoid a violation law or to preserve its entity status. Such legal option must be issued by counsel, and be in form and substance acceptable to the SBIC fund's general partner and the SBA.

No-fault termination or suspension of the Investment Period; No-fault removal of the General Partner. Investors sometimes ask for the right to terminate or suspend the fund's investment period and/or remove the general partner upon an affirmative vote of the limited partners. The Model Agreement is silent on both of these issues. However, in practice, some funds add provisions to their partnership agreements to accommodate the investors' requests. The SBA typically will not permit the termination of the investment period or the removal of the general partner unless the termination and/or removal is tied to a trigger event. Common trigger events include fraud, a material violation of the Small Business Investment Act of 1958 (as amended, the "SBIC Act"), willful misconduct, gross negligence or a material breach of the partnership agreement, in each case, by the general partner (or a member of the general partner). SBA typically requires that these trigger events must also have an adverse affect on the fund.

Upon the occurrence of a trigger event, the investment period is typically suspended for a specified period. During the suspension period, the general partner usually may not call capital or draw on the SBA leverage except to pay partnership expenses and the management fee and, if permitted, to make pre-approved follow-on investments. At any time during the suspension period, the limited partners typically have the right to vote to permanently terminate the investment period. There is no consensus on whether the investment period should be reinstated or permanently terminated at the end of the suspension period if the limited partners do not resolve the issue prior to the end of the suspension period.

Typically, the general partner may cure the trigger event by removing the person responsible for the trigger event.

Excuse Mechanisms. An institutional investor often asks to be excused from an investment if the investment would violate such investor's internal investment policy. On occasion, an investor also asks for the right to withhold its capital contribution or withdraw from the fund if the fund does not comply with such investor's administrative policies. SBA has historically not permitted excuse mechanisms and, therefore, the Model Agreement is silent on this issue.

To accommodate an investor, the fund and such investor may enter into a side letter that lists each investment and/or administrative policy with which the fund agrees to comply, and provides that the investor will have recourse against the fund if the fund does not comply with such policies. The side letter cannot include an excuse mechanism, as the letter must be approved by the SBA as part of the SBIC licensure process. Such side letter should include representations and covenants from the investor that (a) the side letter contains a complete list of the investor's policies that will affect the fund or its business and (b) the investor will update the fund as the policies are modified. In the event that an investor's policy does change, the fund and such investor can amend the side letter with the consent of the SBA For disclosure purposes, the partnership agreement should include a provision stating that either (y) side letters will modify the terms of the partnership agreement, or (z) the fund will not make investments that violate its investors' internal policies as set forth in side letters.

Alternatively, the fund can add a list of prohibited investments and other administrative requirements to the partnership agreement. This method appeals to some general partners because all prohibited investments would be contained in one list. However, it can be disadvantageous from an administrative standpoint if the investors' policies are subjective (*e.g.*, the fund will not make an investment that has an adverse effect on public employees) as opposed to objective (*e.g.*, the fund will not invest in public utilities). In addition, this mechanism is inconvenient if the investor's policies change, because amending the partnership agreement would require an affirmative vote of the limited partners.

Repayment of the SBA Leverage. Investors are often surprised by the number of safeguards built into the Model Agreement to protect the SBA's investment. As discussed above, one mechanism in the Model Agreement to achieve this objective is to prevent the fund from being dissolved until after the leverage and all related fees are repaid. Other mechanisms include:

- The general partner and each limited partner are required to contribute to the fund any amount of their respective capital commitments not previously contributed if, at the time of the leverage is redeemed, the assets of the fund are not sufficient to repay the outstanding leverage and all other amounts owed by the fund to the SBA. Such requirement terminates upon the earlier of (i) the fund's complete liquidation and (ii) one year after the commencement of the fund's liquidation;

- The fund is expressly prohibited from deferring, reducing or terminating a partner's obligations to the fund without the SBA's prior consent; and

To protect the SBA's substantial investment, the Model Agreement includes several mandatory provisions that require that the leverage and fees owed to the SBA be repaid before the limited partners get certain rights or distributions.

- Distributions are only permitted in accordance with the SBIC Act. Investors should note that an SBIC fund is prohibited from returning more than 2% of the limited partners' private capital in any given year without SBA consent.

Each of the above-referenced concepts is encapsulated in mandatory provisions that cannot be modified in the Model Agreement.

Management Fees. Certain investors are wary of the management fee paid to an SBIC fund manager because, during the fund's investment period, the fee is equal to a percentage of the private capital commitments plus the total SBA leverage. Consequently, the management fee can conceivably be double or triple what the same fund manager would have received without leverage. In addition, some investors do not understand whether they will be responsible for paying management fees attributable to the leverage.

Although the Model Agreement is silent on how to calculate the management fee and how the management fee will be paid, management compensation is highly regulated by the SBA because the SBA "has a statutory obligation to assure that SBIC [funds] utilizing government-guaranteed leverage are financially sound and that the government's financial interests are protected."[2] Specifically, the SBA requires that management compensation be determined by multiplying a management fee rate by a management fee base. The Model Agreement further provides that the amount of management compensation must be approved by the SBA.

The maximum management fee rate for an SBIC fund is between 2% and 2.5% depending on the size of the management fee base, with the higher rate available to funds with a smaller base. The management fee base varies depending on whether the fund is in its "initial investment period." The "initial investment period" is typically a five-year period that begins upon the earlier of the fund (a) receiving its SBIC license, (b) making its first investment, and (c) accruing any management fees on the SBA leverage. During the initial investment period, the base is the sum of (a) the private capital commitments, (b) certain distributions previously made to the partners and (c) the amount of SBA leverage that the fund plans to draw based on the committed private capital during the fund's life as reflected on the fund's business plan approved by the SBA. After the initial investment period, the base is reduced to the cost of loans and investments for all active portfolio companies, which results in a substantial decrease in management compensation.

The SBA typically will not permit the termination of the investment period or the removal of the general partner unless the termination and/or removal is tied to a trigger event.

Although the SBA permits a fund manager to charge a fee on the leverage, it does not affect a limited partner's *pro rata* share of the management compensation. Typically, a limited partner is only responsible for contributing to the management compensation an amount equal to its commitment multiplied by the applicable management fee rate. The fund can draw on the leverage to pay the management fee attributable to the aggregate amount of assumed leverage that will be used during the term of the fund.

Conclusion

First time investors, general partners and fund managers are often drawn to the benefits of SBIC funds, but should understand the SBA's rights with respect to SBIC funds before deciding to form or invest in such funds.

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2 SBIC TechNotes Number 7A (revised April 2008).

Choose Your Board Seats Carefully

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This article describes what Section 8 prohibits, explains the key limitations on the reach of Section 8, and notes when interlocks may be challenged under Section 5 of the FTC Act. It then suggests some steps private equity firms can take to reduce their exposure to investigations and lawsuits.

Section 8 of the Clayton Act provides that "[n]o person shall, at the same time, serve as a director or officer in any two [competing] corporations." For many years there were very few cases brought under Section 8, but this is now changing. Two years ago, the Department of Justice filed suit under Section 8 to prevent a company from being able to appoint directors of a competitor. In the past nine months, as a result of a Federal Trade Commission investigation into whether Apple and Google had violated Section 8, two directors who sat on both boards resigned – Google CEO Eric Schmidt from Apple's board, and Genentech CEO Arthur Levinson from Google's board. In addition, well known venture capitalist John Doerr, who sits on Google's board, will not seek re-election to Amazon.com's board, reportedly as a result of the same FTC investigation.

Moreover, in April Sears announced that in order to settle a shareholder lawsuit alleging a violation of Section 8, one board member will vacate his seat and another will not participate in any discussions about the company's women's clothing business, because she also sits on the board of a clothing manufacturer. Finally, Section 8 is currently being invoked by Genzyme in its fight with Carl Icahn. Icahn is seeking to place himself and three associates on Genzyme's board. Genzyme has pointed out that two of Icahn's nominees are directors of Biogen Idec, a competitor, and is urging investors to reject Icahn's slate on the grounds that its election would violate Section 8.

The Chairman of the FTC recently stated that "we will continue to monitor companies that share board members and take enforcement actions where appropriate," and another FTC Commissioner has endorsed using Section 5 of the FTC Act, which gives the FTC broad authority to challenge "unfair methods of competition," to attack interlocks that do not violate Section 8. Moreover, the Department of Justice is actively investigating several potential Section 8 violations.

Private Equity Firms, Hedge Funds and Section 8

Private equity firms and hedge funds have been targets of Section 8 litigation. William Crowley, the Sears director who will vacate his seat in May, is president and chief operating officer of ESL Investments, a hedge fund that owned 54 percent of the outstanding voting stock of Sears, 45 percent of the outstanding voting stock of AutoNation, and 41 percent of the voting stock of AutoZone, Inc., when the Section 8 suit was filed. He sat on all three boards. Plaintiffs alleged that AutoZone competes with Sears in the sale of automobile replacement parts and accessories, and AutoNation competes with Sears in automobile service and repair. Additionally, Oaktree Capital Management, a private equity firm, was sued under Section 8 when it acquired 40 percent of Loews Cineplex Entertainment Group and 17 percent of Regal Entertainment Group, both of which operate movie theatre chains, and placed representatives on both boards.

Although Section 8 investigations and suits involving private equity firms, hedge funds, sector funds, and similar entities — hereinafter referred to as "private equity firms" — have been rare, until recently

Section 8 suits and investigations involving all types of entities have been infrequent. Not only do many private equity funds invest in companies that compete against each other, even if only tangentially, which can be sufficient to create a Section 8 issue, but they invest in companies in high-tech industries where, as a result of new product offerings, a company that is not a competitor today may become one tomorrow. Accordingly, private equity firms need to understand and comply with Section 8.

This article describes what Section 8 prohibits, explains the key limitations on the reach of Section 8, and notes when interlocks may be challenged under Section 5 of the FTC Act. It then suggests some steps private equity firms can take to reduce their exposure to investigations and lawsuits.

Section 8 of the Clayton Act

The purpose of Section 8 is to prevent interlocking officers and directors from facilitating collusion between competing companies, such as price-fixing and market division, by serving as a conduit for competitively sensitive information. It prevents a single person from serving on the boards of two competing corporations, and it also prevents an entity such as a private equity firm from placing two different representatives or agents on the boards of competing companies.

Section 8 is violated if there is a prohibited interlock, even if there is no proof of any harm to competition or any intent to coordinate prices, output, or other business decisions. It can be enforced by the Department of Justice, the Federal Trade Commission, state attorneys general, and private parties. The typical remedy under Section 8 is an injunction prohibiting the offending interlock and future interlocks.

Treble damages are theoretically available to private plaintiffs, but no court has ever awarded damages under Section 8. Nevertheless, no company wants to be subject to a government investigation (or discovery in a private lawsuit) and possible litigation. Both are expensive, time-consuming, and can create disclosure obligations. Moreover, interlocking officers or directors can make a company more vulnerable to claims of price-fixing, customer, territorial, or product allocation, or other agreements not to compete, all of which can have serious civil and criminal consequences.

Limitations on Section 8

There are three important limitations on the reach of Section 8. First, the statute does not apply if an agreement to eliminate competition between the two corporations that have common officers or directors would not "constitute a violation of any of the antitrust laws." Because the Supreme Court has held that a corporation is not capable of conspiring with its wholly owned subsidiary to violate the Sherman Act, Section 8 does not apply to interlocks involving wholly owned subsidiaries. However, the Court left open the question "under what circumstances, if any, a parent may be liable for conspiring with an affiliated corporation it does not completely own." The better-reasoned cases hold that where a parent controls a subsidiary, the parent and the subsidiary cannot conspire. Those cases are in the majority, but there are a few cases holding that a parent can conspire with a majority-owned subsidiary.

Consistent with the case law on parent-subsidiary conspiracy, Section 8 has been held to prohibit interlocks where a parent owns less than 50 percent of an affiliate, but there are no cases addressing the application of Section 8 where the parent owns more than 50 percent but less than 100 percent of the subsidiary. Similarly, there are no cases addressing the situation where there is an interlock between two majority-owned subsidiaries of the same person, such as two portfolio companies of a private equity firm. Nevertheless, where a private equity firm owns 80 to 85 percent of the equity of its portfolio companies and two or more of those companies compete against each other, the risk of an interlock being found to violate Section 8 is very low.

The second limitation on Section 8 is a set of de minimis exceptions. The Act applies only where both companies have capital, surplus, and undivided profits in excess of $25,841,000, a figure that is revised annually. Also exempted from Section 8 are interlocks where the competitive sales of either corporation are less than $2,584,100 (also adjusted annually), the competitive sales of either corporation are less than two percent of the corporation's total sales, or the competitive sales of each corporation are less than four percent of that corporation's total sales.

A third limitation on the operation of Section 8 is a one-year grace period. If, as a result of a change in the capital, surplus, and undivided profits, or in the affairs of the company, a previously eligible director becomes ineligible under the statute, he or she may continue to serve for one year following the date on which the event causing ineligibility occurred.

Section 5 of the FTC Act

Section 5 of the FTC Act prohibits "unfair methods of competition" and it has been used by the FTC to challenge interlocks that violated the spirit and policy of Section 8

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but Section 8 did not reach. Going forward, the most likely use of Section 5 will be to challenge interlocks involving entities other than corporations, and interlocks between potential competitors.

Lessons for Private Equity Firms

The FTC in particular has clearly signaled that it is subjecting interlocks to greater scrutiny. This is but one manifestation of stricter antitrust enforcement by the Obama Administration. In this environment, private equity firms should take several steps to minimize their exposure:

- Identify whether any less-than-majority-owned portfolio companies have competing sales with any other portfolio company before placing representatives on more than one board. As noted above, a private equity firm can violate Section 8 if it has representatives serving on the boards of two competing corporations, notwithstanding that the representatives are different people. While it is a factual question whether a person is serving on a board in his individual capacity or as a representative of the private equity firm, the closer the association between the private equity firm and the director, the more likely that the individual will be found to be a representative. For example, courts are more likely to find that an employee of a private equity firm is a representative of the firm than they are to find that a co-investor is a representative.

- Identify whether any less-than-majority-owned portfolio companies may compete in the future with any other portfolio company as a result of one of them introducing new products, expanding the geographic scope of its operations, or making an acquisition. It is important to note that when the FTC publicly announced its investigation of the Google-Apple interlock in May 2009, it was likely the parties were then exempt from Section 8 because it appears that none of Google's sales that competed with Apple constituted more than 2 percent of Google's sales. It was clear that the parties could become substantial competitors in the future – as they are now, with Google's introduction of Nexus One, a direct competitor to Apple's iPhone – and thus it appears that the FTC was prepared to challenge the interlock under Section 5 of the FTC Act. Accordingly, if one portfolio company has plans that would place it in competition with another portfolio company, especially if those plans have been publicly announced, it would be prudent to avoid placing directors on both boards.

- Monitor these issues on an ongoing basis. For example, a director of a portfolio company should report to the board if he is planning to sit on any additional boards so that the board can determine whether the new directorship would raise Section 8 issues. Similarly, if a portfolio company makes an acquisition or expands its product offerings, a Section 8 analysis should be performed.

- Have a written antitrust compliance policy that alerts all employees to the dangers of antitrust violations and warns employees to avoid communications that could give rise to antitrust issues, and take special care that representatives that sit on portfolio company boards understand the limits on sharing competitively sensitive information.

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Alternative Investment Fund Managers Directive Passes Important Milestone

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The ground has now been cleared for negotiations between the European Council, the European Parliament and the European Commission — a process known as "trilogue" — to begin.

Since it was sprung on an unsuspecting world in April last year, the proposed Alternative Investment Fund Managers[1] Directive ("AIFMD" or "Directive") has galvanized the alternative investment industry, not only in the European Union ("EU"), where it has direct effect, but in the U.S. and other third countries indirectly but materially affected by the Directive. In seeking to limit access to EU investors for alternative fund managers, advisors and promoters based outside the EU, the Directive has attracted criticism from the highest levels, including from the U.S. government.

May 2010 marked an important step in the progress towards approving the Directive, as the end game now approaches. The ground has now been cleared for negotiations between the European Council ("Council"), the European Parliament ("Parliament") and the European Commission ("Commission") — a process known as "trilogue" — to begin. If a common text is agreed upon over the summer, the AIFMD would come into effect in the second half of 2012. However, in a surprise development, the "trilogue" talks have temporarily collapsed, which means a common text will not be agreed until September 2010 at the earliest.

The EU decision-making process is complex, but for the purposes of this analysis the key fact in the process is this: there are two competing versions of the Directive: one from the Council and one from the Parliament. While either text will have significant consequences for alternative investment fund managers ("AIFMs"), those consequences will be even more serious if the more hard line Parliament text prevails. Though trade associations have undertaken to continue their lobbying efforts, it is uncertain to what extent they will prevail in softening the Parliament's line, which is likely to attract the support of the Commission, given that the Parliament text is closer to the original Commission proposal than the Council text. It will certainly be an uphill task to obtain any concessions, given that financial institutions generally remain held in low esteem.

Differing Views

The most important areas where the Parliament and Commission take different views are the following.

Third country issues

This is perhaps the most critical aspect to the AIFMD, and one where many both within and outside the EU, including the U.S., have been concerned about the potential effect on the global alternatives industry. U.S. Treasury Secretary Geithner wrote to the Commission in March, giving a none-too-coded warning about the consequences of the EU adopting a protectionist stance.

There are two distinct aspects to this area: first, where an AIFM is based in the EU, and manages a fund that is not in the EU, and second, where neither the AIFM nor the fund are in the EU (the issue that particularly concerned Secretary Geithner).

EU-based AIFMs with non-EU fund. The Parliament text grants the EU AIFM a marketing "passport" for the non-EU fund, enabling the fund to be marketed throughout the EU, if the country in which the fund is located satisfies the following conditions:

[1] In the EU "investment manager" is synonymous with U.S. nomenclature, "investment advisor."

- it must have ”high enough” standards to combat money-laundering and terrorist financing (presumably implementing the Financial Action Task Force (“FATF”) standards would be sufficient; this would cover both Delaware and Cayman funds, for example);
- it must grant reciprocal access to the marketing of EU funds on its territory; and
- it must have agreements in place with the EU Member States where marketing is intended, covering exchange of information relating to taxation and monitoring (the latter being between the supervisor of the fund and the Member State competent authority).

Given that the third condition would apparently require the supervisor of the fund to make appropriate agreements with the authorities of all 27 EU Member States before the EU AIFM could market the fund throughout the EU, the operation of the “passport” would be extremely cumbersome at best.

If the country in which the fund is located satisfies the first two conditions, the EU AIFM can market the fund in any Member State that has entered into agreements with that country, which satisfies the third condition. This is, in effect, a more restrictive version of the private placement regime that currently operates in the EU. However, the second condition (reciprocal access) may prove problematic, given the difficulties this has caused in the past (for instance, the dispute over reciprocal access for EU UCITS[2] funds in the U.S.). See Box 1 for a summary of the relevant conditions.

The Council text is much less restrictive as regards EU AIFMs managing non-EU funds. Provided that the EU AIFM complies with all the requirements of the AIFMD except those relating to depositaries (though it must ensure that a third party is appointed as depositary and notify its regulator of the identity of that third party), and there are “appropriate” co-operation agreements in place (the Commission is to specify what “appropriate” means in this context) between the AIFM’s regulator and the supervisory authority of the non-EU fund allowing an efficient exchange of information so that the regulator can carry out its duties under the AIFMD, the non-EU fund can be marketed to professional investors in the territory of the AIFM. That means that in order to market the fund across the EU, all 27 separate sets of agreements must be in place, which, as noted above, would be extremely cumbersome.

Non-EU AIFM with non-EU fund (*e.g.*, a U.S. manager of a Cayman Islands fund). The Parliament text provides that in order to access the EU markets - that is, to market their funds in the EU, whether those funds are located in the EU or not — non-EU AIFMs must agree to comply with the requirements of the AIFMD. In such cases, their supervisors must agree to act as agents of the new European Securities and Markets Authority (“ESMA”) in the supervision of the AIFMs. That may be problematic: whether the SEC, for instance, would be prepared to act as anyone’s agent must be open to doubt. But even if these requirements are satisfied, a non-EU AIFM will only be able to market a non-EU fund in the EU if the country in which the fund is located satisfies the three conditions set out above for the marketing of a non-EU fund by an EU AIFM. While the lack of discrimination between EU and non-EU AIFMs in this respect is welcome, the same problems as outlined above apply here also. In particular, it will be very difficult at best for a non-EU AIFM to market a non-EU fund across the EU.

The Council text is again less restrictive. Member States can allow marketing to professional investors in their territories provided that the AIFM complies with certain limited provisions of the AIFMD (mainly those relating to disclosure in Articles 19-21), and there are “appropriate” cooperation arrangements in place between the competent authorities of the Member State in which the marketing is to take place and the regulator of the non-EU AIFM that allow an efficient exchange of information to allow those competent authorities to carry out their duties under the AIFMD. See Box 2 for a summary of the relevant conditions.

EU investors in non-EU funds. The Parliament text also seeks to restrict the ability of EU investors to invest in non-EU funds. If the jurisdiction in which the fund is located does not meet the conditions outlined above (and in Box 1) for the marketing of a non-EU fund by an EU AIFM, and certain other conditions are not met, EU investors cannot invest in the fund, even if no marketing has taken place in the EU and the decision to invest has been of the investor’s own accord. There is no equivalent in the Council text.

If this provision appears in the final version of the AIFMD, it would potentially have a significant impact on the ability of institutional investors in the EU, such as pension funds, to invest in alternative investment opportunities worldwide, including in funds managed by U.S.

2 A “UCITS” is a fund that meets the requirement of the UCITS Directive and can be freely marketed across the EU. “UCITS” means “undertaking for collective investment in transferable securities.” Although the range of investments available to UCITS funds is now wider than transferable securities, the name has stuck.

investment advisors. It will be interesting to see whether any such investor, or a wealthy individual, might seek to challenge this provision as contrary to its rights under the European Convention on Human Rights (in particular, its rights concerned with property).

Private equity

The private equity industry has, from the outset, opposed the indiscriminate application of the AIFMD to its members, and it looks as though Parliament has reacted to their concerns, at least in part. Certain provisions of the AIFMD will, under the Parliament text, not apply to private equity AIFMs — in particular, the need to ensure that a depositary is appointed, and the requirement to hold a fixed amount of capital. In this respect, the Parliament text is more favorable to the industry than the Council text, which has no such exclusions.

However, when it comes to the treatment of portfolio companies, the Parliament text is far more intrusive. Whereas the Council text exempts investments by private equity funds in small and medium enterprises ("SMEs") from any disclosure requirements, and in any event requires disclosure only where the fund acquires more than 50% of the voting rights in the company, the Parliament text would trigger disclosure requirements when a far lower threshold was reached — more than 10% of the voting rights - and would reduce the scope of the exemption to companies with fewer than 50 employees. As the disclosure requirements cover subjects such as finances, development plan and conflicts policy, they will put private equity at a disadvantage when compared to other investors (*e.g.*, sovereign wealth funds or wealthy individuals), because these other investors will not be required to make similar disclosures. The Parliament appears to acknowledge that this is unfair, as it has inserted a provision into the Directive calling on the European Commission to review existing company law legislation to see that companies owned by private equity are not at a disadvantage when compared to companies owned by other persons. But this is cold comfort, given the time that such an exercise is likely to take and the further delay before any change could take effect.

Depositaries

The Parliament text expands the definition of depositary to include not just EU credit institutions (banks) but also MiFID[3] investment firms and other authorized EU entities subject to prudential supervision. It also allows a depositary to delegate tasks to third parties outside the EU, provided that it performs due diligence in the selection and oversight of the sub-depositary, remains liable for the actions of the sub-depositary, and the third country in which the sub-depositary is located satisfies similar conditions to those set out above for the marketing of non-EU funds in the EU. While the additional flexibility regarding delegation is helpful, it seems odd that delegation to a non-EU entity is dependent on whether the country of the entity grants equivalent access to EU funds, since that is irrelevant to the issue here (namely the custodianship of money and/or other assets).

The depositary will remain liable for any losses of financial instruments unless this is as a result of *force majeure* or an unforeseeable external event. The depositary will also be liable for the actions of sub-depositaries unless the depositary is legally prevented from exercising custody functions in the country in question, or could not due to unforeseeable external events. The depositary will also not be liable for loss of assets if the sub-depositary is contractually able to reuse or transfer the assets.

Under the Council text, depositaries may be EU credit institutions, MiFID investment firms or entities capable of being UCITS depositaries. They are liable for the loss of any instruments held in custody, including instruments held by sub-custodians (unless, in the latter case, the depositary contracts out of its liability and it is reasonable for it to do so). They are also liable for any other loss to the AIFM, the fund, and to investors in the fund, even if that loss is beyond their control (except where *force majeure* applies).

The Council text is, however, less restrictive as regards delegation of functions to third parties: provided due skill and care are exercised in the selection, appointment and periodic review of the third party, record-keeping and verification functions can be delegated (including to entities outside the EU), and the third parties in turn can sub-delegate these tasks. Custodian functions may be delegated only if there is an objective reason for doing so, and the custodian satisfies certain conditions (such as being subject to regulation and periodic audit, as well as operating segregation of client assets from its own).

Given the similarities between the two texts in this area, agreement on a common text should be relatively straightforward. However, this may have unfortunate consequences for the industry given the increased costs that are likely to be incurred because of the strict liability that depositaries will face, as well as the unintended consequence of greater systemic risk, as assets (and thus risk) are concentrated among fewer entities able to act as depositaries.

[3] The EU directive governing the provision of investment services.

Areas of Agreement

In other important areas, the respective Parliament and Council texts are very close. It is therefore reasonably certain that these provisions will appear wholly or largely unaltered in the final text.

Delegation. Both texts require AIFMs that intend to delegate functions to third parties to inform their regulator. The Parliament text provides that the regulator has one month to object. If the Parliament text prevails, this is likely to lead to regulators pre-approving any delegation by AIFMs. This would seem an unnecessary level of regulatory interference, given that UCITS fund managers, dealing primarily with retail clients, would not be subject to a similar provision. Both texts also provide that the liability of the AIFM is unaffected by any delegation.

While both texts restrict delegation of portfolio or risk management functions, the Parliament text would allow such delegation only to another AIFM authorized to manage a fund of the same type. In contrast, the Council text allows delegation to any entity authorized or registered for the purposes of asset management and subject to supervision, and to any other entity on the approval of the AIFM's regulator; delegation may be to an entity outside the EU provided that, in addition to the above requirements, there is a cooperation agreement between the supervisor of the non-EU entity and the AIFM's regulator. The more restrictive Parliament text is likely to make global fund management more difficult; at the very least, it will require some AIFMs to amend their business models.

"Valuators." The original Commission proposal required the AIFM to ensure that each fund that it managed had an independent valuer (called a "valuator"). The Parliament text has softened this, allowing the AIFM to be the valuator of the fund provided that there are safeguards in place allowing the valuation function to be independent from the portfolio management function. In addition, Member States may require a third party, such as an auditor, to check the independence of the valuation when it is done "in house."

The text also specifies that when an AIFM delegates valuation tasks, this does not shift liability from the AIFM to the external valuator. This presumably applies only where the AIFM is acting as its own valuator; it makes no sense if a third-party valuator is appointed, in which context the valuator, and not the AIFM, is taking responsibility for valuing the assets of the fund.

The Council text avoids the ugly word "valuator," but otherwise the texts are very similar.

Capital requirements. Both texts align the capital required for AIFMs with that required for managers under the UCITS directive. This means a maximum of €10 million (the original Commission proposal was uncapped) for portfolios over €250 million. In addition, up to 50% of the capital requirement for AIFMs can be supplied by bank or insurance company guarantee, if the Member State of the AIFM so decides.

The original minimum capital requirement of €125,000 (also taken from the UCITS directive) remains. However, where the fund is self-managed (*i.e.*, there is no external AIFM, as with a U.K. investment trust), that amount rises to a minimum of €300,000. The reasoning for the significant differential is not made clear.

Leverage. The Commission text required the Commission to set limits to the amount of leverage AIFM could employ. The Parliament text amends this — it is for AIFM to set the amount of leverage, which will be monitored by the competent authorities of the AIFM. This seems a sensible change, and is virtually identical to the Council text, under which the AIFM's regulator may impose leverage limits or other restrictions on the management of the fund if it thinks that this is necessary to ensure the stability and integrity of the financial system. The main difference between the two texts is that the Parliament version enables ESMA to override competent authorities if it feels that the level of leverage is inappropriate. Since fund leverage has been historically low (certainly when compared to that of banks), and the recent FSA survey indicates that no single fund poses a systemic risk, one wonders whether these provisions are likely to cause a concern for AIFMs in practice. Perhaps the more interesting issue is that under the Parliament text, we may be seeing the first signs of ESMA acting as the pan-EU "super-regulator," the rise of which has often been predicted.

Remuneration. Both texts have remuneration rules, which were originally aimed at the banking sector. The main difference is that under the Parliament text, the detail is prescriptive, whereas the Council text requires AIFMs to apply the principles set out in a way and to the extent that is appropriate to their size and the size of the funds that they manage. Given that the remuneration provisions were designed for banks and do not take account of the different compensation structures in the alternative asset management industry, it is to be hoped that the Council text prevails.

As noted above, though it remains possible that some of the AIFMD provisions that trade associations and their members find particularly difficult could be diluted in the trilogue process between now and the Parliament's "first reading" in July, one gets the impression that the time for that may have passed, and that any concessions at this stage are likely to be at the margin.

Even when passed, the Directive will not be required to be implemented in the national law of Member States until the second half of 2012, giving AIFMs time to plan and restructure in anticipation. That will include not just EU investment managers and advisors, but those in the U.S. and elsewhere outside the EU, who operate in and gather assets from the EU.

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Box 1

Conditions for Offshore (Non-EU) Fund Marketed in EU by an EU AIFM

The EU Parliament text

The fund's jurisdiction must:

- have standards equivalent to EU standards to combat money laundering and terrorist financing;
- grant reciprocal access to the marketing of EU funds on its territory; and
- have agreements in place with the EU Member States where marketing is intended, covering exchange of information relating to taxation and monitoring (the latter being between the supervisor of the fund and the Member State competent authority).

The EU Council text

- EU AIFM to comply with all the requirements of the AIFMD except those relating to depositaries (though it must ensure that a third party is appointed as depositary and notify its regulator of the identity of that third party).
- Appropriate cooperation agreements are in place between the AIFM's regulator and the supervisory authority of the non-EU fund.

Box 2

Conditions for Offshore (Non-EU) Fund Marketed in EU by a non-EU (*e.g.*, U.S.) AIFM

The EU Parliament text

- Non-EU AIFM to agree to comply with the requirements of the AIFMD and its supervisor must agree to act as agent of ESMA.
- The country in which the non-EU AIFM is located (and, if different, the fund) must satisfy the conditions for the marketing of a non-EU fund by an EU AIFM (see Box 1).

The EU Council Text

- Member States can allow marketing to professional investors in their territories provided that the AIFM complies with certain limited provisions of the AIFMD.
- Appropriate cooperation agreements are in place between the AIFM's regulator and the supervisory authority of the non-EU fund.

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