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THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE:
THE EUROPEAN UNION GIVES PRIVATE EQUITY FUND MANAGERS THE “SOCIAL MARKET ECONOMY” TREATMENT

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I. INTRODUCTION

The Alternative Investment Fund Managers Directive (AIFMD) entered into force in July 2011, with the European Union’s (EU) member states having until July 2013 to implement the AIFMD into national law. There is a further one-year “transitional period,” ending in July 2014, before fund managers will have to comply with the AIFMD. Broadly speaking, the AIFMD regulates fund managers of those alternative investment funds (AIFs) which are either established or marketed in the EU. AIFs are investment funds that are not regulated as retail funds, meaning that they are funds which pursue hedge, private equity, commodities, or direct real estate investment strategies and only accept sophisticated investors.

The AIFMD imposes a variety of obligations upon fund

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2. However, as of August 2013, 16 of the EU’s 28 member states had failed to implement the AIFMD into national law. John Kenchington, Hedge Fund Rules Absent in 16 EU States, FIN. TIMES, Aug. 25, 2013, http://www.ft.com/intl/cms/s/0/f3ad2d00-0a60-11e3-aeab-00144feabc0.html#axzz2riG5jZ11.

3. AIFMD, supra note 1, art. 61.

4. Id. art. 2(l).

This article focuses on how the regulation of private equity fund managers under the AIFMD is intended to correct perceived problems within the private equity industry. This is in keeping with the EU's aim of establishing a less bloody form of the free market, the "social market economy." This is allegedly at odds with private equity. Part II provides an overview of private equity funds, while financial regulation in the EU and the promotion of a social market economy are discussed in Part III. The provisions of the AIFMD that apply specifically to private equity fund managers are reviewed in Part IV. This article concludes in Part V that this regulation of private equity fund managers was intended to suppress this space in the market, not remedy common areas of abuse.

II. THE ROLE OF PRIVATE EQUITY FUNDS

Private equity funds invest in corporations which are not listed on an exchange. Private equity fund managers raise investment capital from sophisticated investors, usually institutional investors. Funds are generally structured as limited partnerships in England or offshore jurisdictions, such as the Cayman Islands; investors subscribe as limited partners. The fund will have a set life span, commonly ten years, and a specific investment focus. As an example, the focus could be investing in technology start-ups in Scandinavia. The private equity fund manager comes to control the fund in one of two ways: (1) the private equity fund manager is the general partner of the limited partnership or (2) the fund's general partner is a wholly-owned subsidiary, a shell company, of the private equity fund manager—and that subsidiary, as the general partner, appoints the private equity fund manager as the investment fund's manager. Under the terms of the limited partnership

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6. These obligations include requirements for managers of AIFs to be authorized and regulated; to maintain capital adequacy; to maintain appropriate governance; to have robust systems in place to manage risks, liquidity, and conflicts of interest; and to prevent the delegation of key functions to third parties.


8. See infra Part II.

9. See infra Part III.

10. See infra Part IV.

11. See infra Part V.
agreement governing the fund the investors are committed to make their capital available for the life of fund and will have no redemption rights, making private equity investments highly illiquid.

Private equity is controversial because of the scale of the industry, its use of leverage, its perceived short-termism, and its lack of disclosure. During the course of 2012, private equity funds invested €36.5 billion ($48.2 billion) in approximately 5,000 corporations in Europe. In 2013, private equity fund managers raised $431 billion and the industry has three trillion dollars of assets under management globally. The sheer scale of the private equity industry has raised concerns in certain quarters, particularly regarding its "lack of disclosure and transparency ... and the position of non-shareholder stakeholders ... within these portfolio [corporations]."

The alleged secrecy surrounding private equity managers leads to the perceived risks of leverage and short-termism. When a private equity fund invests in a corporation it does not do so simply by buying equity, the fund will finance its investment partly through debt. Upon acquisition, the debt becomes the liability of the target corporation. This leaves the target corporation with a high debt-to-equity ratio. In 2007, the Socialist Group in the European Parliament published a report on investment funds (Report) that was highly critical of how the use of debt in private equity acquisitions left target corporations highly leveraged. The Report stated that in order to service the high level of debts imposed upon it, the corporation "will be forced to use most of its earnings for this purpose and is ... no longer capable of investing in ..."
further development of the company."

Further, it has been suggested that the high levels of debt financing in private equity acquisitions create systemic risk. The Financial Services Authority, the U.K.’s former financial services regulator, cited the Royal Bank of Scotland’s aggressive expansion into the leveraged finance market as a factor in the scale of the bank’s losses.

In order to recoup the investment within the lifespan of the fund, private equity managers are often accused of seeking to maximize profits in the short-term, even if that jeopardizes the long-term survival of the corporation. The Report claims that private equity investment threatens the long-term viability of the corporation and, as such, employees’ commitment to their corporation. Syed Kamall, a Member of the European Parliament, has stated that there is an “antipathy” in Europe towards how private equity firms “buy and sell large numbers of shares in [corporations] and the consequent frequency in the change of control.” For these reasons, private equity has been described as posing “a direct threat to the European social model.”

III. THE AIFMD, FINANCIAL REGULATION IN THE EU AND THE PROMOTION OF A SOCIAL MARKET ECONOMY

The management, establishment, and marketing of investment funds is already heavily regulated within the EU, so it is not as if the

18. Id. at 17.
21. VAN DEN BURG & RASMUSSEN, supra note 17, at 20.
managers of existing AIFs are operating outside the boundaries of existing law. However, it hardly seems controversial to state that the EU saw the financial crisis as an opportunity to regulate financial markets and services. In addition to the AIFMD, other EU legislation is intended to impose various clearing, reporting, and risk mitigation obligations on derivatives,25 as well as increased prudential requirements on banks and financial services firms.26 There are also proposals which will kill off the over-the-counter derivatives market entirely in favor of central exchanges, or organized and multilateral trading facilities.27

This layer of financial regulation is subordinate to the Treaty on European Union (TEU), a fact overlooked by many commentators.28 The TEU lays out “the mission and values of the European Union” which guides the purpose and intent of all EU legislation.29 The post-Treaty of Lisbon version of the TEU introduced the phrase “social market economy.”30 The promotion and development of a “social market economy” is listed as a key aim of the EU in article 3(3). Article 3 of the TEU states that “[t]he Union shall establish an internal market. It shall work for the sustainable development of Europe based on . . . a highly competitive social market economy.”31


28. TEU, supra note 7.
29. DAMIAN CHALMERS ET AL., EUROPEAN UNION LAW 40 (2d ed. 2010).
31. TEU, supra note 7, art. 3.
“Social market economy” is a significant phrase, it demonstrates an intent, at the EU-level, to impose a “political economy . . . redefined by the ideas that have shaped the socially inclusive and institutionally coordinated [social market economies] on the Continent and in Scandinavia, rather than by the liberal market economies . . . of the Anglo-Saxon countries.”

Perhaps private equity funds managers are not welcome participants in the EU’s social market economy. For instance, in 2005 former Vice Chancellor of Germany, Franz Münterfering, described private equity funds as “Heuschrecken” (locusts).

Against this background the AIFMD can be seen as part of a wider ambition to create a different form of capitalism, rather than another example of post-crisis regulation. Specific provisions of the AIFMD, aimed at private equity fund managers, make this clear.

IV. THE AIFMD’S PRIVATE EQUITY PROVISIONS

Under the AIFMD, private equity fund managers will be subject to various reporting obligations upon acquiring shares in a corporation. In addition, they will become subject to anti-asset stripping provisions.

A. Reporting Obligations

The AIFMD imposes several obligations on fund managers when one or more of their AIFs acquire shares in a non-listed corporation. When an AIF reaches, exceeds, or falls below the following voting rights thresholds it must notify its national regulator: ten percent, twenty percent, thirty percent, fifty percent, and seventy-five percent. This measure is presumably intended to provide regulators with greater knowledge about the investments of private equity funds.


34. AIFMD, supra note 1, art. 27(1).
When an AIF, or more than one AIF managed by the same manager, acquires control over a corporation – defined as fifty percent or more of the voting rights of that corporation – then the fund manager must notify the controlled corporation, its shareholders, and the national regulator of the fund manager. As part of the process of notifying the corporation, the fund manager is under an obligation to ensure that the employees are informed that an AIF has gained control of the corporation, including information about the identity of the different shareholders and the identities of the ultimate beneficial owners of the corporation. The EU has previously set out requirements for corporations to inform or consult with their employees. However, the AIFMD requirements seem to go further than previous legislation by requiring fund managers to reveal far more detailed information regarding the ultimate beneficial owners of the corporation than would ordinarily be available via public records.

The fund manager must also disclose to the controlled corporation, the shareholders, and its national regulator, its identity as the manager of the AIF as well as information on the conflicts of interest policy between the fund manager, the AIF, and the corporation. It must also disclose the policy for external and internal communication relating to the corporation, in particular as regards employees. Either the AIF, or the manager acting on the AIF’s behalf, must “disclose [the AIF’s] intentions with regard to the future business of the non-listed company and the likely repercussions on employment, including any material change in the conditions of employment.”

There is also a requirement that the controlled corporation’s or the AIF’s annual report contain “a fair review of the development of the [corporation]’s business representing the situation at the end of the period covered by the annual report.” The fund manager is under an obligation to ensure that this information contained in the annual report

35. Id. art. 26(5).
36. Id. art. 27(2).
37. Id. art. 27(4).
38. Id. art. 27(3)(b).
40. AIFMD, supra note 1, art. 28(2).
41. Id.
42. Id. art. 28(4).
43. Id. art. 29(2).
is given to the controlled corporation's employees.44 Taken together, these disclosure requirements seem to suggest that the EU believes that private equity funds and their managers cannot be trusted and that a high standard of scrutiny must be imposed on them.

B. Asset Stripping

The disclosure requirements are by no means the most intrusive element of the AIFMD relating to private equity fund managers. Article 30 relates to "asset stripping" and sets out a list of prohibited activities that the private equity fund manager of the shareholder AIF cannot take with respect to a controlled corporation. For twenty-four months following the acquisition of control of the corporation the fund manager shall not: (i) facilitate, support, instruct, or vote in favor of any distribution (including dividends), capital reduction, share redemption, or acquisition of the corporation's own shares; and (ii) must use its best efforts to prevent such actions.45

These asset stripping restrictions are subject to a number of exemptions. The most important of which is likely to be that a distribution or dividend can be paid if it would not cause net assets to fall below subscribed capital or would be within net profits of the previous financial year.46 Arguably, these restrictions imposed upon private equity AIFs and their managers are unreasonably interventionist. Such restrictions seem to fundamentally misunderstand, and perhaps demonize, private equity firms.

V. Conclusion

Despite suggestions to the contrary,47 private equity funds did not cause the financial crisis. However, the financial crisis did provide a convenient opportunity to regulate them.48 The EU made a "political"49 decision to regulate a sector it found distasteful and force it

44. Id. art. 29(1)(a).
45. Id. art. 30(1).
46. Id. art. 30(2).
47. See Gregory, supra note 19.
49. Payne, supra note 15, at 582.
to comply with the aim of achieving a social market economy. This
distaste is arguably misplaced. Private equity firms, unlike banks which
provide loans to corporations, hold an equity stake and often invest in
sectors where the fund managers have specific expertise and experience.
Private equity managers are not simply looking to recover their
principal and interest like a bank; private equity managers are looking to
maximize their profits over the life of the fund. In these circumstances,
a private equity fund and its manager are "true business partner[s],
sharing in [the corporation’s] risks and rewards, with practical advice
and expertise." Therefore, in comparison to traditional providers of
corporate finance, private equity is significantly more aligned with the
long-term interests of corporations and as such is closer to the ideals of
the social market economy than private equity’s critics would consider
to be the case.

If there is a problem with private equity funds it is that,
collectively, they provide a relatively poor return on investment. This is
largely because of the limited partnership structure which allows the
fund manager to take out a management fee of two percent of total
assets under management regardless of the performance of the fund, and
an additional twenty percent of any profits earned. The gross returns
of private equity funds have beaten the S&P 500 average. However,
ceases are taken into account, the return to an investor is “equal to or
lower than S&P 500 average returns.” The Kauffman Foundation
conducted a survey of its history of investing in private equity and
concluded that the limited partnership model was “broken” because
limited partnerships failed to “generate returns that exceed[ed] the
public market.” The Kauffman Foundation concluded that the two

50. KEITH ARUNDALE, GUIDE TO PRIVATE EQUITY 13 (British Private Equity & Venture
Capital Assoc., 2010), available at http://www.bvca.co.uk/Portals/0/library/Files/Website%20files/2012_0001_guide_to_privat
e_equity.pdf.
51. This is referred to as “2 and 20.”
52. Gregory, supra note 19, at 43.
53. Id.
54. DIANE MULCAHY ET AL., “WE HAVE MET THE ENEMY... AND HE IS US”: LESSONS
FROM TWENTY YEARS OF THE KAUFFMAN FOUNDATION’S INVESTMENTS IN VENTURE CAPITAL
FUNDS AND THE TRIUMPH OF HOPE OVER EXPERIENCE 3 (Ewing Marion Kauffman
12/05/we%20have%20met%20the%20enemy%20and%20he%20is%20us(1).pdf.
55. Id. at 4.
and twenty fee structure was to blame for this performance.\textsuperscript{56}

The poor performance of private equity fund managers may be a cause for concern, but investment fund managers are already subject to strict rules on how their funds are marketed under the Markets in Financial Instruments Directive\textsuperscript{57} and national legislation.\textsuperscript{58} The AIFMD will introduce further restrictions on how investment funds are marketed in the EU.\textsuperscript{59}

If anything, the poor performance of private equity funds will be exacerbated by the AIFMD. The Bank of New York Mellon has estimated that the AIFMD and other new regulations will add an extra $300 million to $500 million in costs to the EU’s alternative investment fund management industry.\textsuperscript{60} Inevitably fund managers will pass these costs onto investors. As the Financial Times notes, this increased cost could make investors “inclined to dispense with more expensive active managers and instead opt for cheaper passive funds.”\textsuperscript{61} Passive index tracker funds, which simply invest across an index of publicly traded securities, have significantly lower management fees and are by nature far less involved in the management of corporations than private equity funds.

\textsuperscript{56} See id.

\textsuperscript{57} MiFID, supra note 24, art. 19. Article 19 imposes “conduct of business obligations” upon investment firms that have been authorized by an EU member state regulator in accordance with MiFID. By way of example, any marketing materials must be “fair, clear and not misleading” (art. 19(2)); and, the fund manager, when marketing the fund, must have regard to the “knowledge and experience” of the client (art. 19(5)).

\textsuperscript{58} In the U.K. the MiFID conduct of business obligations are extended beyond the bounds of MiFID in order to ensure that a broader range of fund managers are captured. For instance, in accordance with section 238 of the Financial Services and Markets Act 2000, the marketing (referred to as “promotion”) of investment funds is generally restricted to persons who have been appropriately authorized by the FCA (either under MiFID or the RAO). When promoting an investment fund such an authorized firm must ensure that its marketing materials are not likely to be disseminated to retail clients and the fund would be a suitable investment for a potential investor. Essentially these requirements are intended to restrict the promotion of investment funds to sophisticated investors only. The full requirements relating to firms authorized to promote funds by the FCA are set out in Chapter 4.12 of the Conduct of Business Sourcebook. Unauthorized firms may also promote investment funds to investors but only if the investors are based outside the U.K.; investment professionals; sophisticated investors; or, high net worth corporations, associations or individuals (See FPO, supra note 24).

\textsuperscript{59} See AIFMD, supra note 1, ch. VI.


\textsuperscript{61} Id.
Arguably, the purpose of the AIFMD is to either compel private equity funds to conform to the EU’s social market economy ambitions or to make such funds so expensive that investors will look elsewhere, driving private equity out of the EU. This may quicken the EU’s aim of founding a social market economy but the question is if this economy will prove to be so stagnant that the very workers the EU is trying to protect will ultimately prove to have been poorly served by the AIFMD. Therefore, it is imperative that private equity fund managers, as a major source of capital for corporations, find a way to operate within the confines of the social market economy and the AIFMD.