

## Alternative Investment Fund Managers Directive

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You will doubtless be aware of the fact that the European Commission has, in response to proposals from the European Parliament, produced a draft Directive called the Alternative Investment Fund Managers Directive. Since it was published at the end of April the BVCA has been heavily engaged in discussions with the UK and other authorities about the Directive and the serious concerns that we have. EVCA has formed a Task Force to co-ordinate the European industry's responses and input, and Margaret Chamberlain (who chairs the BVCA Regulatory Committee) and Sue Woodman (who chairs the BVCA Legal and Technical Committee) are participating in that work, together with support from the members of their committees.

The draft is already under discussion in the European Council and it is impossible to predict the direction that it will take. It is possible that there could be a range of outcomes for private equity and venture capital firms. The Directive currently covers managers of all types of fund (private equity, hedge fund, real estate, commodity, etc.) but it is entirely possible that the scope of the Directive could change during the course of negotiations. Members of the BVCA Regulatory and Legal and Technical Committees have prepared the following notes on key aspects of the proposal which are of particular interest and relevance to private equity and venture capital firms. We would be very interested in receiving any comments or observations that you may have, please feel free to send them to Carmen Murray: [cmurray@bvca.co.uk](mailto:cmurray@bvca.co.uk).

Kind regards,

**Simon Walker**

Chief Executive

*The British Private Equity and Venture Capital Association*

## EC directive on alternative investment fund managers - comments on the scope and regulatory requirements

Margaret Chamberlain

Partner Travers Smith LLP

Chair BVCA Regulatory Committee

### INTRODUCTION

The European Commission has proposed a Directive on Alternative Investment Fund Managers, which in its current form would cover managers of all types of collective investment vehicle including private equity, real estate, debt, commodity, film and hedge funds, venture capital trusts and investment trusts. It proposes a common regulatory regime for such managers, who will also have the benefit of a passport so that they can market their funds across Europe, which would reduce the cost and legal uncertainty that can arise with cross-border marketing.

The Commission has set a very ambitious timetable for the Directive, which, if met, would mean that it would come into force at the end of 2011. There will be a transitional period giving EU managers of EU domiciled funds one year to comply after the Directive comes into force. Where funds are outside the EU, the non-EU jurisdictions have three years to meet specified EU standards if their funds are to continue to be marketed within the EU.

The purpose of this section is to outline our current understanding of the intended scope and application of the Directive and to highlight those provisions which we believe will have the most significant impact on private equity and venture capital firms. The Directive leaves considerable room for uncertainty in relation to its scope; many provisions are unclear and some provisions appear contradictory. The BVCA Regulatory Committee is actively participating in the submissions and debates that are taking place.

### PART A

#### 1. Scope

In this note we set out our current understanding of the draft, informed by the Commission's Impact Assessment and Frequently Asked Questions documents and by some recent clarification provided by the Commission. However some important aspects of the scope provisions are not clear. This is the beginning of a long process of negotiation and clarification.

The current draft of the Directive appears to regulate three key aspects:

- (a) alternative investment fund managers;
- (b) the marketing of alternative investment funds; and
- (c) the provision of services to alternative investment funds by third parties.

Key introductory points about the scope of the Directive are that:

- it provides a regulatory regime for fund *managers*, not advisers;
- not all fund managers are automatically caught because there are exemptions designed to exclude managers of smaller funds. Managers who are exempt under the fund size exemption can opt in to the Directive in order to obtain the marketing passport;
- it appears that some UK managers may also be excluded, because they are only 'sub-managers', with another entity overseas (such as a general partner) having the overall responsibility for fund management;

- **it is not necessarily a good thing to be outside the Directive. Three years after the Directive comes into force funds which are managed outside Europe (with perhaps an EU adviser) can only be marketed across Europe if the manager is licensed in a jurisdiction recognised by the Commission as “equivalent” (in which case it can apply for an authorisation under the Directive which allows its fund to be marketed in Europe – see 1.2.3 below). If an EU fund manager is exempt because the fund he manages is below the threshold tests then the manager will not have the marketing passport, but he will be able to market his funds in other Member States on such basis as is permitted by their national laws. The effect of EC Treaties is to prohibit Member States from discriminating against fund managers and funds domiciled in other Member States so, in any particular Member State, the rules should be the same for all managers of smaller funds, but there will be no single EU regime. This position is not clear from the wording of the Directive but represents our understanding of the Commission’s intentions.**

These points are explained in more detail below.

There is a real concern that some proponents of the Directive are seeking to create a ‘fortress Europe’, permitting only funds managed in Europe or to European standards to be marketed to professional investors. This is in part a reaction to the Madoff scandal; some EU countries have always been hostile to the marketing of non-EU funds, over which they feel they have no control, and the Madoff affair has given weight to their views. The fact that EU investors (including professional investors) were exposed to Madoff through funds based and/or marketed in the EU has clearly influenced the Commission, particularly in relation to investor protection issues such as marketing, custody and valuation of investments.

We will be seeking to make all interested parties aware of the huge damage which will be caused by such an approach, which may well trigger a ‘trade war’ and lead to reciprocal restrictions which could seriously affect overseas investment (such as from the U.S.) into European managed funds.

## **1.1 Alternative investment fund managers**

The Directive regulates “alternative investment fund managers” (“AIFM”), defined as a person who manages an “alternative investment fund” (“AIF”). The Commission indicates that this is because the responsibility for almost all decision-making in relation to the management of the fund lies with the manager. In this regard it refers not only to investment decisions but also the management of relations with investors and the organisation of administrative functions, including valuation and safekeeping. Thus by “manager” the Commission seems to have in mind the entity with the direct responsibility to investors for the management *and* administration of the fund. In UK terminology, it is the fund “operator”. There are many entities in the EU who have responsibility for the management of fund portfolios, but who are not the “manager” of the fund in this wider sense.

The definition of “alternative investment fund” appears to include co-investment and carried interest schemes, investment trusts and VCTs as well as all non-UCITS investment funds (no matter where established). The Directive does not, however, apply to the management of pension funds or to managers of non-pooled investment vehicles “such as endowments or sovereign wealth funds or assets held on own account by credit institutions, insurers and reinsurers, or to actively managed investments in the form of securities, certificates, managed futures or index linked bonds”. It is not clear on what basis the Commission has concluded that sovereign wealth funds and EU banks should be exempted.

Thus we consider that the current scope and impact of the draft is as follows:

### **1.1.1 EU-based managers**

The only entity in the EU permitted to manage and administer an AIF is a manager whose head and registered office is in an EU Member State and who is authorised under the Directive, unless one of the limited exemptions applies. This is regardless of where the fund is established.

An AIFM authorised in one EU State is able to provide management services to an AIF domiciled in another EU State by using a passport under the Directive. It can provide the services either from its home State or by establishing a branch in the EU State in which the fund is domiciled.

The principal exemptions are for:

- (a) managers where the fund portfolios under management do not in total exceed €500million, *provided that* those funds are not leveraged and that investors have no redemption rights for five years from initial constitution of each fund;
- (b) managers where the fund portfolios under management do not in total exceed €100million (including assets acquired through the use of leverage);

- (c) managers who manage only funds which are not domiciled in the EU, provided that the funds are not marketed in the EU; and
- (d) EU banks and EU insurance companies.

(There are uncertainties in relation to both value limits (a) and (b), including: (i) it is not clear how the €500m limit applies to funds which are not themselves leveraged, but have leverage at the investee company level; (ii) it is not clear whether portfolio size is to be calculated on a gross or net basis and on a committed capital or NAV basis; and (iii) neither level addresses fluctuations in asset values, which could severely limit the usefulness of the exemptions.)

Exempted managers have no rights under the Directive and cannot therefore use the marketing passport (see below) to market their funds in Europe outside their Home State. Those exempt under paragraphs (a) and (b) above will, however, be permitted to “opt in” so that they can have the passport, but they must then comply with the requirements of the Directive. In any event it appears that the effect of the Directive is to require all Member States to introduce an authorisation regime which would also cover exempt managers, as it provides that the only firms who can manage/market funds in Europe are those authorised under the Directive or, if they are not covered by the Directive, who are authorised in accordance with the national law of a Member State. Whilst UK firms have been authorised for many years, this is not the case in other parts of Europe.

### 1.1.2 Non-EU based managers

Managers which do not have their head and registered office in an EU State cannot become authorised as an AIFM under the Directive (although they may be entitled to an authorisation under the Directive which gives them a licence to market their funds - see below).

## 1.2 Marketing the alternative investment fund

### 1.2.1 What is a non-EU fund?

The Directive refers to a ‘fund domiciled in a Member State’ which is referred to below as an ‘EU fund’. Generally an English limited partnership would be an EU fund, but it is not clear how a fund would be treated if it is constituted under the laws of one jurisdiction, but ‘operated’ elsewhere, for example an English limited partnership with a Guernsey general partner.

### 1.2.2 EU funds

EU funds can only be marketed in EU Member States to professional investors if there is an AIFM authorised under the Directive, in which case they can be marketed: (a) by that AIFM; or (b) by a MiFID investment firm.

### 1.2.3 Non-EU funds

For the first three years after the Directive comes into force, a non-EU fund may continue to be marketed in an EU State if permitted by the laws of that State. Essentially the current position continues for that period. After that, interests in a non-EU fund can be marketed to professional investors in all EU States:

- (a) by the authorised EU AIFM of that fund if the non-EU country in which the fund is domiciled has agreed to comply with OECD standards on exchange of tax information;
- (b) by its AIFM established outside the EU if that manager obtains a special authorisation (see below); or
- (c) by a MiFID investment firm if the fund is managed by an AIFM who falls within (a) or (b).

EU States will be able to authorise AIFMs established in non-EU countries (e.g., the U.S.) to market funds in the EU. Such special authorisation can only be given if the EU Commission has decided that:

- (a) the prudential regulation and ongoing supervision of managers in the relevant country are equivalent to those under the Directive and are “effectively enforced”;
- (b) EU managers have effective and comparable market access in that country; and
- (c) that country has agreed to comply with OECD standards on exchange of tax information.

There will clearly be some difficult political issues in connection with the assessments of equivalence and reciprocity. Notably, equivalent “prudential regulation” implies that the relevant country will impose regulatory capital requirements on managers, this would be a significant departure for the U.S.

## 1.2.4 The marketing passport

The Directive permits an AIFM authorised under the Directive to market its AIFs to professional investors in all EU States. For the purposes of the Directive “professional investor” has the narrower meaning under MiFID. This means that firms will not be able to treat as professional a prospective investor solely on the grounds of knowledge and experience. Prescriptive quantitative tests will need to be met. This will rule out marketing to most high net worth or sophisticated individuals.

Each State can decide if it permits marketing more widely and impose conditions if it does; there is no passport for marketing to retail investors.

## 1.3 Provision of services in respect of alternative investment funds by third parties

### 1.3.1 Where there is no AIFM authorised under the Directive

The Directive appears to state that other EU investment firms authorised under MiFID can only provide investment services in respect of funds, if the fund can be marketed under the Directive, i.e. if it has an AIFM authorised under the Directive (including an overseas manager with a marketing authorisation). There are at least two possible interpretations of this provision, both of which are serious.

One would prohibit advisors from recommending units in a fund with no AIFM authorised under the Directive to EU investors or arranging their subscription through discretionary portfolio mandates or otherwise.

The other interpretation would, on a worst case, appear to prevent any EU investment firm from providing any investment service to such an AIF (including acting as broker, adviser or placement agent), even if that AIF does not wish to market its shares or units to EU investors.

We assume that, whatever these provisions mean, they are not intended to prevent services being provided to managers who are exempt under the Directive.

### 1.3.2 Where there is an AIFM authorised under the Directive

Where there is an AIFM authorised under the Directive, we believe the effect of the current draft is that the AIFM can, subject to meeting the onerous requirements set out later in this note, delegate certain functions to third parties.

## 1.4 1.4 Position of EU managers who are exempt

It appears that the Commission intends that in future only regulated entities may manage and market funds in Europe. As a result all managers will be regulated, even if they fall outside the scope of the Directive because their funds are below the threshold size. The obvious risk is that regulators will apply most or all of the regulatory provisions of the Directive, even to firms outside its scope.

Exempt managers will not benefit from the marketing passport, although we understand the intention to be that they can market their funds in accordance with the national law of each Member State. The Commission is of the view that the effect of Treaty freedoms is that Member States cannot have laws which discriminate against fund managers domiciled in other Member States and their funds. Therefore if a local exempt manager can promote his fund in his country on a particular basis, a manager from another Member State should also be able to do so. This is the theoretical position today, but not necessarily the actual experience. It is not yet clear how and if Member States will change their laws but the Directive might provide an opportunity to put pressure on them to provide real equal treatment.

## PART B

### If my firm is caught, what are the key implications?

Part B of this note describes some of the key requirements applicable to the AIFM who is a venture capital or private equity fund manager. These requirements will certainly apply to an AIFM based in the EU. It is not clear to what extent the Commission will expect similar requirements to be imposed on a fund manager outside the EU by a third country recognised as “equivalent” (see the special authorisation regime described in paragraph 1.2.3 above). The Directive also has provisions on short selling, liquidity management and investing in securitised investments, which are not described below.

## 2. Capital requirements

The Directive imposes capital requirements by requiring the fund manager to maintain a minimum level of *own funds*. There is no capital requirement on the fund itself.

As with the current FSA regulatory capital rules applicable to investment managers, the requirement is not to hold money in a bank account, but rather that capital should be retained in the fund manager. Capital essentially means “shareholder funds” (after deducting any losses and intangible assets such as goodwill). LLPs may treat capital contributions as own funds if the LLP agreement imposes significant restrictions on withdrawal and repayment of capital.

The requirement is that own funds must be the *higher of*:

- (a) one-quarter of fixed annual overheads, including salaries, guaranteed bonuses and rent; and
- (b) €125,000 *plus* 0.02% of the amount by which the total value of alternative investment fund portfolios under management exceeds €250 million.

The formula is based substantially on the capital requirement imposed on managers of UCITS funds (European funds intended to be suitable for retail investors). Significantly, the UCITS legislation provides an absolute cap on the capital requirement at €10m, but there is no equivalent cap proposed for managers of alternative investment funds.

For many UK firms this could represent a significant increase over their current capital requirement.

## 3. Conduct of business requirements: general principles

There are three general principles requiring the fund manager to:

- (a) act honestly with due skill, care and diligence and fairly in conducting its activities;
- (b) act in the best interests of the fund, the investors in the fund and the integrity of the market; and
- (c) ensure that all investors are treated fairly.

There is considerable overlap between these principles and the Directive’s more detailed provisions.

The requirement on the manager to act in the best interests of the fund may seem unremarkable at first. However, it is potentially very significant. There is a conflict in a requirement to act at all times in the interests of the fund, in the interests of investors *and* in the interests of the integrity of the market. These are three very different constituencies and their respective interests may frequently be mutually exclusive. In particular, whilst the interests of investors collectively may be equated with the interests of the fund, their individual interests may diverge, for example when one investor wishes to redeem or reduce their commitment. What about the classic case of a manager operating more than one fund with overlapping investment objectives? MiFID lays down requirements on the manager to allocate investment opportunities fairly but there is no equivalent provision in this proposal. There is implicit recognition that the obligations cannot each be absolute, in the requirement elsewhere to identify, manage and disclose conflicts of interest. It is to be hoped that these issues will be recognised expressly, at least in a new recital and perhaps also in implementing measures.

No investor may obtain a preferential treatment over any other, “unless this is disclosed in the [fund] rules or instruments of incorporation”. It is not clear whether this is a requirement to disclose the possibility that some investors may be given preferential treatment, or to disclose the nature of the preference.

## 4. Conflicts of Interest

The manager must take all reasonable steps to identify conflicts of interest:

- (a) between the manager (including its employees and controllers) and fund investors; and
- (b) between one investor and another.

The manager must operate effective systems and controls designed to prevent conflicts from adversely affecting the interests of the fund and investors. The manager must disclose the general nature and sources of conflicts of interest to investors if those arrangements are not sufficient for it to be confident that risks of damage to investors interests will be prevented.

This regulatory obligation is broadly the same obligation as UK firms are already subject to under MiFID and FSA rules.

The manager must segregate within its own operating environment tasks and responsibilities which may be regarded as incompatible with each other.

## **5. Risk management**

### **5.1 The manager must:**

- (a) separate tasks and responsibilities for risk management and for portfolio management;
- (b) implement risk management systems to measure and monitor the risks associated with each fund investment strategy and to which each fund is exposed and stress test the risks associated with each investment; and
- (c) follow a documented and regularly updated due diligence process for investment.

Under MiFID, firms are required to have separate compliance, risk and internal audit functions – but only where this is proportionate to the nature, scale and complexity of their business. There is no such subtlety in the current proposal, which may be a significant concern for smaller managers, in particular.

## **6. Appointment of an independent valuer**

An AIFM must ensure that its funds have a valuer, independent of the manager, responsible for valuing fund assets and fund units. All assets and units of the fund must be valued at least annually and each time shares or units are issued or redeemed.

The manager must ensure the valuer uses existing appropriate and consistent valuation standards to value the fund assets in order to reflect the net asset value of the fund units.

The rules for valuation and for calculating the net asset value per unit must be laid down in the law of the country where the fund is established or in the rules of the fund or instruments of incorporation.

Three years after the Directive is implemented, non-EU valuers will only be permitted if the Commission has determined that the valuation standards and rules in the relevant country are equivalent to those in the EU.

This requirement is excessive and an unnecessary overhead for typical private equity funds leading to additional costs borne by investors with no corresponding benefit to them. If private equity firms remain within the scope of the Directive the BVCA will be seeking to restrict this requirement to funds where investors subscribe or redeem at net asset value, which we believe is more proportionate and will in practice exclude private equity funds.

## **7. Appointment of an independent custodian**

A separate custodian must be appointed to have safekeeping of the monies and financial instruments belonging to the fund. The custodian must also verify that the fund (or the manager on behalf of the fund) has obtained the ownership of all other assets the fund invests in, and is obliged by the Directive to act independently and solely in the interests of investors.

The fund manager is not permitted to have custody of money or financial instruments. This cuts across many structures in use where the fund manager also provides custody. It may prevent assets being registered in the name of the general partner of a limited partnership, for example. There will therefore be significant changes to the custody structures for many funds – likely requiring investor consent – and additional cost for investors.

The custodian must be a bank with its registered office in the EU even if the fund is non-EU. There are many entities which are authorised to provide custody within the EU which would not meet these requirements. European branches of US or other third country banks are not eligible.

A custodian may generally only delegate to another EU bank. Three years after implementation, it will be possible to delegate to a sub-custodian which is not an EU bank but only:

- (a) in respect of a non-EU fund;
- (b) to a sub-custodian in that fund's jurisdiction; and

(c) if the Commission has determined that the prudential regulation, supervision and standards of the country of the sub-custodian are equivalent to those imposed by the Directive.

The fact that it will be impossible to delegate to a non-EU custodian in respect of an EU fund may impede the fund's ability to invest outside the EU, for example because the principal custodian may not be a member of the relevant local securities depository. In some jurisdictions, title to certain assets can by law only be held by a local custodian. Most established custodians currently rely on intermediated sub-custody networks.

There is specific provision about the liability of the custodian. It will be liable to the fund and investors for any losses suffered by them as a result of its failure to perform its obligations. If it loses financial instruments it will have to prove that it could not have avoided the loss which has occurred.

The custodian is also to be liable for delegates, which may be a further significant impediment to sub-custody networks.

The BVCA also regards these provisions as excessive, impracticable and unnecessary. They might not be capable of being given effect in some existing funds where the custody arrangements will be part of the agreement and all investors might need to consent to the change. It will impose additional expense on the fund which will be borne by the investors. The current UK regime (itself derived from the Markets in Financial Instruments Directive ("MiFID") requires managers to ensure that client assets are segregated from the manager's own assets and to provide appropriate safekeeping for them. The BVCA will be seeking to ensure that this provision prevails, there is no reason why a firm caught by this Directive should have to meet different standards to those imposed under MiFID.

## **8. Delegation by the fund manager**

There are extremely onerous requirements on a manager which intends to delegate to someone else the task of carrying out any of its functions. Its functions include not only portfolio management but also administration and marketing. It appears therefore that the provisions would extend to the appointment of third party administrators and placement agents.

The fund manager must obtain prior authorisation from its regulator for each and every delegation on a case-by-case basis.

This creates significant moral hazard for EU regulators.

Where portfolio management or risk management is delegated then it can only be delegated to another fund manager authorised under the Directive to manage a fund of the same type. This would prevent funds with a geographical investment focus outside the EU delegating some management to a local regional manager.

In the case of any delegation the third party must be creditworthy and the people who conduct its business must be of sufficiently good repute and sufficiently experienced.

The manager may only delegate administrative functions to an entity based outside the EU if that third party is authorised to provide administration services or registered in its country and is subject to prudential supervision, and there is a co-operation agreement with its regulator.

The fund manager must demonstrate that any delegate is qualified and capable of undertaking the functions in question, and that it was selected with due care. The manager must be able to monitor the delegate effectively, to give further instructions and to withdraw the delegation with immediate effect when this is in the interests of investors.

The third party may not sub-delegate

These requirements in relation to delegation are far greater than those that apply to portfolio managers under MiFID, including those portfolio managers who have retail clients and again the BVCA will be seeking significant changes in this area.

## **9. Marketing procedures: marketing cross-border**

Before a manager can market a fund to professional investors in its own EU State it must first provide its regulator with certain information about each fund that it intends to market. The regulator may impose restrictions or conditions on the marketing.

The manager's regulator must inform the manager within ten working days whether it may commence its activities. However, if the fund is established in a third country the regulator is entitled to take longer if necessary to be satisfied that the conditions imposed by the Directive have been met.

The manager must notify its own regulator of its intention to market a fund to professional investors in other Member States, together with certain documents and details about the fund. These need not necessarily be translated if they are in a "language customary in the sphere of international finance". The manager's own regulator must transmit this within ten working days of receipt to the relevant authorities of the Member State where the fund will be marketed and notify the manager that it has done so. The manager can only market cross-border from the date it receives this notification.

The marketing arrangements in any other Member State has to be in accordance with its laws. It appears that the host member state may have some supervisory role although this is not clear.

Any change to the particulars that have been provided must be described to the manager's own regulator at least one month before implementing the change. Since this would include changes to documents such as the PPM, this does not fit with the established approach to private placement.

Member States have the option to allow funds to be marketed to retail investors in their country and to impose stricter requirements on the fund or the manager if they allow it at all.

The BVCA considers that these provisions are unnecessarily bureaucratic, and will at best impede and at worst prevent, fund raising activity. The requirements for prior marketing notifications are onerous for firms and regulators and do not reflect the commercial reality of an iterative and interactive marketing process and assume that documentation is always in final form before marketing commences. We will be seeking significant changes to ensure that firms continue to have the flexibility to move quickly to respond to investor demands.

## **10. Conclusion**

As it stands the burdens imposed by the Directive far exceed any benefit to be derived from the 'marketing' passport. Whilst its scope provisions are to some extent ill-defined, there is clearly a move towards creating a 'fortress Europe', raising barriers to investment in funds managed outside the EU. The BVCA believes this approach is flawed, fails to take account of the nature of the fund industry and its investors and gives rise to significant risk of retaliatory action which would seriously threaten the ability of EU firms to raise money overseas. We are and will be making these points forcefully in the coming months.

## EC Directive on Alternative Investment Fund Managers - comments on disclosure requirements

**Simon Witney**

*Partner SJ Berwin LLP*

*BVCA Legal & Technical Committee*

One of the three stated aims of the Directive is to “improve public accountability for AIF holding controlling stakes in companies”. This aim, perhaps unlike the others, is specifically aimed at the private equity industry.

The Directive tries to achieve that public accountability by including some provisions which would require fund managers which are caught by the directive to make extensive disclosures about the investments held by the AIF that they manage. These sit on top of requirements for various disclosures to regulators, investors and employee representatives.

The detail of the reporting requirements, together with a comparison with the requirements of the Walker Guidelines, is included in the table below.

### **PUBLIC DISCLOSURE**

The Directive would require an audited annual report to be made publicly available in respect of each AIF managed by an affected AIFM. That report will have to be published within four months of the year end, which is equivalent to the time-frame required of a fully listed UK company, but compares to the six months which is permitted for a company quoted on AIM (or an unlisted public company) and the nine months given to all private companies under current UK law.

The level of disclosure required in that annual report will also increase significantly where a “controlling stake” in a company (other than an SME - see box) has been acquired. Controlling stake is defined to include any shareholding over 30%, and will therefore include companies which are not actually “controlled” by the fund. These enhanced disclosures will, in some respects, increase the level of disclosure required to the equivalent of a publicly listed company, and in certain areas go further than for those for companies quoted on AIM.

Unlike the UK’s Walker Guidelines, the portfolio companies themselves will not be required to make disclosures - it is the funds which will have to make disclosures about them. This is logically inconsistent with the general approach taken by company law, which imposes reporting obligations on companies (and their directors) rather than on shareholders (who do not have formal authority to control the business, and who may not have the actual power to do so).

Of particular note is the need to include forward looking statements in the fund’s annual report about the “expected progress on activities and financial affairs” of each portfolio company. Information is also required about operational and financial developments, revenue by business segment, financial and other risks, employees and asset sales.

The level of information which a private UK company will (indirectly) have to disclose will therefore increase significantly if a private equity fund covered by the Directive takes a 30% stake, and the same requirements would not apply to other private companies. That leaves a private equity owned business on an uneven playing field when compared to companies owned by, for example, individuals or sovereign wealth funds.

**The definition of an SME is, in summary, an “enterprise” (that is, an entity engaged in economic activity) which is autonomous (or, if linked with other companies, then the linked companies as a whole must be considered), and which has:**

- fewer than 250 employees; and either
- an annual turnover not exceeding €50 million; or
- a balance sheet total not exceeding €43 million.

## DISCLOSURE TO INVESTORS

The Directive includes a comprehensive set of disclosures which must be made to investors. These are unlikely to be a problem for private equity funds because the level of disclosure to investors is already considerable. Some of the requirements do not, however, make sense in the context of a private equity fund and are clearly drafted with hedge funds in mind - such as the requirement to disclose the proportion of assets subject to "spread arrangements" and the arrangements for liquidity.

One potential concern is that it is apparently not possible (as the Directive is currently drafted) to contract out of the requirements. While it should be possible to agree confidentiality restrictions as part of the fund's terms, so that all investors are bound to keep the information confidential, some investors will not be willing or able, for legal and / or commercial reasons, to agree to be bound by such restrictions. In those cases, it may be necessary to decline to accept certain investors into a fund, or to accept that disclosures made to them may fall into the public domain. It would not appear to be possible, as it is at present, for investors to agree to forgo the information which the Directive will require the managers to disclose to them.

## DISCLOSURE TO OTHER SHAREHOLDERS AND STAKEHOLDERS

There are some rather odd requirements to notify the other shareholders in a private company when a stake of 30% or more is acquired by an AIFM. It is hard to see how the other shareholders will not know this, but the requirement is unlikely to be problematic. Of more concern is the requirement to disclose to the company, its shareholders and representatives of employees (or the employees themselves) the development plan for the company, the policy for preventing conflicts and the communication plan for the company. These are matters which company law reserves for the board, not the shareholders, and moreover, if it is a minority shareholder, the investor may not have any ability to determine these matters. This disclosure goes further than required of any other entity which acquires a 30% plus stake in a private company, including a listed company which takes such a stake in a private company.

It is likely that any disclosures made will become a matter of public knowledge, as it appears that there is no ability to impose confidentiality restrictions on this information.

## PUBLIC TO PRIVATE TRANSACTIONS

The Directive would stipulate that a company which is de-listed by an AIF must continue to comply with the requirements of the Transparency Directive for quoted companies for two complete financial years following the date of its withdrawal from the regulated market. That means that disclosure requirements which are not useful or necessary for private companies (if they were, presumably all private companies would have to comply with them forever) are imposed on private companies for two years if, but only if, an AIF owns a controlling stake in them.

## REPORTING TO REGULATORS

AIFM would be required to report various matters to the "competent authority" (the FSA in the UK). Again these requirements appear to be focused on hedge funds, requiring disclosure of matters such as fund level leverage and short selling. They would probably not be problematic for private equity funds, but would seem to impose an unnecessary administrative burden and may give rise to problems because of their lack of clarity (for example, the manager would need to report the proportion of assets "subject to special arrangements arising from their illiquid nature", which presumably would be all of the assets in most private equity funds). The authorities will apparently share such information with each in order to monitor potential consequences of AIFM activity for "systemically relevant financial institutions across the EU and/ or for the orderly functioning of the markets of which AIFM are active".

The Directive says it is about regulation of AIFM, not regulation of AIF. However, even setting aside the requirements for the regulators to be provided with extensive information on the funds themselves, there are a number of worrying indications that the Directive opens the door for product regulation in the future. Numerous powers are given to the European Commission to introduce further implementing measures. Both the risk management and the liquidity management provisions could potentially be the basis for restrictions on permitted investments and exposures in future.

No responsibility can be accepted by the BVCA Regulatory and Legal & Technical Committees or contributors for action taken or not taken as a result of information contained in this Legal & Technical and Regulatory Bulletin – specific advice should always be taken in each situation.



**Comparison of disclosure obligations between the draft EU Directive on Alternative Investment Fund Managers and the Walker Guidelines - Elizabeth Ward, Counsel, Linklaters LLP**

The following is a brief comparison of the disclosure obligations contained in:

- the proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers issued by the European Commission on 30 April 2009; and
- the Walker Guidelines for Disclosure and Transparency in Private Equity, November 2007.

	Disclosure Obligations contained in the proposed EU Directive	Disclosure Obligations contained in the Walker Guidelines
<b>1</b>	<b>Who do the obligations apply to? (Article 2)</b>  The Directive will apply on a mandatory basis to Alternative Investment Fund Managers ("AIFM") managing Alternative Investment Funds ("AIF") in the EU but will not apply to managers who manage less than (i) EUR 100 million of assets; or (ii) EUR 500 million provided the funds are not leveraged and investors have no redemption rights for five years from initial constitution of the fund.	<b>Who do the obligations apply to?</b>  UK portfolio companies and private equity firms as defined below. Compliance with guidelines is on a "comply or explain" basis.
<b>2</b>	<b>Definition of AIFM and AIF (Article 3)</b>  AIFM is defined as any legal or natural person whose regular business is to manage one or more AIFs.  AIF means any collective investment undertaking (including investment compartments of it) whose object is the collective investment in assets and which does not require authorisation pursuant to Article 5 of Directive 2009/XX/EC (the UCITS Directive).	<b>Definition of Private Equity Firms and Definitions of Portfolio Company</b>  <b>Private Equity Firm definition</b> A firm authorised by the FSA that is managing or advising funds that either own or control one or more UK companies or have a designated capability to engage in such investment activity in the future, where the company or companies are covered by the enhanced reporting guidelines for portfolio companies.  <b>Portfolio Company definition</b> A UK company acquired by one or more private equity firms: <ul style="list-style-type: none"> <li>• with a market capitalisation of more than GBP 300 million (if a public to private) or an enterprise value of more than GBP 500 million (otherwise);</li> <li>• with more than 50% of the revenues generated in the UK; and</li> <li>• more than 1,000 employees (full-time equivalents) in the UK<sup>1</sup>.</li> </ul>
<b>3</b>	<b>Ongoing public disclosure</b>  No disclosure by portfolio companies, disclosure about them is required by the AIFM.  <b>Article 19</b> For each of the AIF it manages an AIFM shall publish an annual report for each financial year. The annual report shall be published no later than four months following the end of the financial year. The annual report <sup>2</sup> shall at least include: <ul style="list-style-type: none"> <li>• a balance-sheet or a statement of assets and liabilities;</li> <li>• an income and expenditure account for the financial year; and</li> <li>• a report on the activities of the financial year.</li> </ul> <b>Article 29 (enhanced annual report)</b> <b>Exemption:</b> This does not apply where the issuer or non listed company concerned is a small or medium enterprise i.e. has less than 250 employees, has an annual turnover not exceeding Euro 50m and/or an annual balance sheet not exceeding Euro 43m.  The AIF annual report shall include the following additional information for each issuer and non listed company in which the AIF has a controlling influence <sup>3</sup> : <ul style="list-style-type: none"> <li>• operational and financial developments; presentation of revenue and earnings by business segment; statement on the progress of company's activities and financial affairs; assessment of expected progress on activities and financial affairs; report on significant events in the financial year;</li> <li>• financial and other risks: at least financial risks associated with capital structure;</li> <li>• employee matters: turnover, terminations, recruitment; and</li> <li>• statement on significant divestment of assets.</li> </ul>	<b>Content of enhanced disclosure by a Portfolio Company</b>  Enhanced disclosure by portfolio companies, including a business review which substantially conforms with section 417 of the Companies Act 2006 (including s417(5) which otherwise only applies to quoted companies). Such reporting should focus on substance rather than form and on the economic reality of the company and its legal structure. The additional disclosures comprise: <ul style="list-style-type: none"> <li>• identification of the private equity fund or funds that own the company;</li> <li>• identification of senior executives or advisers in charge of the respective fund;</li> <li>• details regarding the composition of the board; and</li> <li>• business review, conforming with s417 Companies Act (which applies to both unquoted and quoted companies) including S417(5) which only applies to quoted Companies. S417(5) requires (to the extent necessary for an understanding of the development, performance or position of the company's business) information on: <ul style="list-style-type: none"> <li>• the main trends and factors likely to affect the future development, performance and position of the company's business;</li> <li>• information about environmental matters including the impact of the company's business on the environment, the company's employees, and social and community issues - including information about any policies of the company in relation to those matters and the effectiveness of those policies; and</li> <li>• information about persons with whom the company has contractual or other arrangements which are essential to the business of the company.</li> </ul> </li> </ul>

<sup>1</sup> The GMG has recommended in its second report on compliance with the Walker Report (30 April 2009 report) that the definition is widened so that only one of the additional conditions, that is either the revenue or the employee thresholds, needs to be fulfilled as well as the market cap/enterprise value limb, for the Guidelines to apply.

<sup>2</sup> NB. The accounting information in the annual report will need to be audited and the auditor's report, including qualifications, reproduced in full in the annual report.

<sup>3</sup> A controlling influence is defined as an AIF which either individually or in aggregate acquires 30% or more of the voting rights of an issuer or of a non listed company domiciled in the EC or has concluded an agreement to that effect.

Disclosure Obligations contained in the proposed EU Directive	Disclosure Obligations contained in the Walker Guidelines
<p><b>3 (con.) Who do the obligations apply to? (Article 2)</b></p> <p>In respect of <i>listed</i> companies also: the composition and operation of the administrative management and supervisory bodies and their committees;</p> <ul style="list-style-type: none"> <li>• prescribed details relating to capital structure; and</li> <li>• the holders of any securities with specific control rights and a description of those rights<sup>4</sup>.</li> </ul> <p>In respect of <i>unlisted</i> companies also:</p> <ul style="list-style-type: none"> <li>• an overview of the management arrangements, the nominal value and number of shares subscribed, in total and by class;</li> <li>• the rights attaching to each share class;</li> <li>• where relevant, any provisions relating to conversion of shares from bearer to registered form;</li> <li>• the amount of subscribed capital paid up at the time the company is incorporated or authorised to commence business; and</li> <li>• the nominal value or number of shares paid up other than in cash, with details.<sup>5</sup></li> </ul> <p>The information above shall also be provided to all representatives of employees within four months of the financial year end.</p>	<p><b>Who do the obligations apply to?</b></p> <p>The audited reports and accounts shall be:</p> <ul style="list-style-type: none"> <li>• published on the company's website;</li> <li>• made available no more than 6 months after the year-end;</li> </ul> <p>Interim reports giving a brief account of major developments shall be:</p> <ul style="list-style-type: none"> <li>• published on the company's website; and</li> <li>• made available no more than 3 months after mid-year.</li> </ul> <p><b>Communication by a Private Equity Firm/Annual Review</b></p> <p>A private equity firm should publish an annual review accessible on its website or ensure regular updating of the following:</p> <ul style="list-style-type: none"> <li>• a description of the way in which the FSA-authorized entity fits into the firm of which it is a part with an indication of the firm's history and investment approach, including investment holding periods, where possible illustrated with case studies;</li> <li>• a commitment to conform to the guidelines on a comply or explain basis and to promote conformity on the part of the portfolio companies owned by its fund or funds;</li> <li>• an indication of the leadership of the UK element of the firm, identifying the most senior members of the management or advisory team and confirmation that arrangements are in place to deal appropriately with conflicts alongside its fiduciary responsibility for management of the fund or funds;</li> <li>• a description of UK portfolio companies in the private equity firm's portfolio; and</li> <li>• a categorisation of the limited partners in the funds or funds that invest or have a designated capability to invest in companies that would be caught by the Guidelines, indicating separately a geographic breakdown between UK and overseas sources and a breakdown by type of investor.</li> </ul>
<p><b>4 Disclosure to investors (Article 20)</b></p> <p>The AIFM should ensure that the AIF investors receive the following information before they invest in the AIF and any changes to it:</p> <ul style="list-style-type: none"> <li>• a description of the investment strategy and objectives of the AIF, all the assets which the AIF can invest in and of the techniques it may employ and of all associated risks, any applicable investment restrictions, the circumstances in which the AIF may use leverage, the types and sources of leverage permitted and the associated risks and of any restrictions to the use of leverage;</li> <li>• a description of the procedures by which the AIF may change its investment strategy and/or investment policy;</li> <li>• a description of the legal implications of the contractual relationship entered into for the purpose of investment, including information on jurisdiction, applicable law and on the existence, or not, of any legal instruments providing for the recognition and enforcement of judgement on the territory where the fund is domiciled;</li> <li>• the identity of the AIF's depository, valuator, auditor and any other service providers and a description of their duties and the investors' rights should any failure arise;</li> <li>• a description of any delegated management or depository function and the identity of the third party to whom the function has been delegated;</li> <li>• a description of the AIF's valuation procedure and, where applicable, of the pricing models for valuing assets, including the methods used in valuing hard-to-value assets;</li> <li>• a description of the AIF's liquidity risk management, including the redemption rights both in normal and exceptional circumstances, existing redemption arrangements with investors, gates, side pockets and how the AIFM ensures a fair treatment of investors;</li> <li>• a description of all fees, charges and expenses and of the maximum amounts thereof which are directly or indirectly borne by investors;</li> </ul>	<p><b>Reporting to Limited Partners/Investors</b></p> <p>Private equity firms should:</p> <ul style="list-style-type: none"> <li>• follow established guidelines such as those published by EVCA for the reporting on and monitoring of existing investments in their funds (frequency, form, summary of each investment by the fund, detail of limited partner's interest in the fund, details of management, other fees attributable to the general partner); and</li> <li>• value investments in their funds using either valuation guidelines published by the International Private Equity and Venture Capital Board (IPEV) or Private Equity Industry Guidelines Group (PEIGG) or such other standardised guidelines as may be developed in the future.</li> </ul>

<sup>4</sup> These requirements are set out in the Takeover Directive - Directive 2004/25/EC, Article 10(1) (a) and (d). The draft EU Directive also refers to Article 46a (1) of Directive 78/660/EEC (relating to annual accounts of certain types of company), although this Article reference does not exist in the reference Directive.

<sup>5</sup> These requirements are set out in Directive 77/91/EEC - Article 3 (b), (c), & (e) to (h) which is cross referred to.

	Disclosure Obligations contained in the proposed EU Directive	Disclosure Obligations contained in the Walker Guidelines
4 (con.)	<p><b>Who do the obligations apply to? (Article 2)</b></p> <ul style="list-style-type: none"> <li>whenever an investor obtains a preferential treatment or the right to obtain preferential treatment, the identity of the investor and a description of this preferential treatment; and</li> <li>the latest annual report.</li> </ul> <p>For each AIF an AIFM manages, it shall periodically<sup>6</sup> disclose to investors:</p> <ul style="list-style-type: none"> <li>the percentage of the AIF's assets which are subject to spread arrangements arising from their illiquid nature;</li> <li>any new arrangements for managing the liquidity of the AIF; and</li> <li>the current risk profile of the AIF and the risk management systems employed by the AIFM to manage these risks.</li> </ul> <p><b>Article 23 - Disclosure to investors of leverage employed at the fund level</b></p> <p>For AIFM's who employ high levels of leverage (it appears this means at the fund level) on a systematic basis, the AIFM must disclose to investors:</p> <ul style="list-style-type: none"> <li>the maximum level of leverage which the manager may use as well as any right of re-use of collateral or any guarantee granted under the leveraging arrangement; and</li> <li>on a quarterly basis, the total amount of leverage employed by the fund in the preceding quarter.</li> </ul>	<p><b>Who do the obligations apply to?</b></p>
5	<p><b>Disclosure following acquisition of a controlling influence in non-listed companies and issuers (Article 27 and Article 28)<sup>7</sup></b></p> <p><b>Exemption:</b> This does not apply where the issuer or non listed company concerned is a small or medium enterprise i.e. less than 250 employees, has an annual turnover not exceeding Euro 50m and/or an annual balance sheet not exceeding Euro 43m.</p> <p><b>Article 27 - notification</b></p> <p>The Directive imposes requirements for AIFM managing AIF which are in a position to exercise a controlling influence over a non-listed company or has an agreement to this effect, to make certain notifications to the non-listed company and all other shareholders within four trading days of reaching the position, namely:</p> <ul style="list-style-type: none"> <li>the resulting situation in terms of voting rights;</li> <li>the conditions under which the 30% threshold was reached, including information about the identity of the different shareholders involved; and</li> <li>the date on which the threshold was reached or exceeded.</li> </ul> <p><b>Article 28 – disclosure on acquisition of a controlling influence</b></p> <p>If the holding is a <i>non-listed</i> company the following must be made available to the company, its shareholders and representatives of employees (or where there are none, to the employees themselves):</p> <ul style="list-style-type: none"> <li>the identity of the AIFM which either individually or in a consortium have triggered the requirement;</li> <li>the development plan for the unlisted company;</li> <li>its policy for preventing and managing conflicts, in particular between the fund manager and the listed company; and</li> <li>its policy on how it communicates with stakeholders, in particular as regards employees.</li> </ul>	<p><b>Responsibility at a time of significant strategic change</b></p> <p>In particular at a time of strategic change, a private equity firm should commit to ensure timely and effective communication with employees, either directly or through its portfolio company as soon as confidentiality constraints cease to be applicable. In the event that a portfolio company encounters difficulties that leave the equity with little or no value, the private equity firm should be attentive not only to full discharge of its fiduciary obligation to the limited partners but also to facilitating the process of transition as far as it is practicable to do so.</p>

<sup>6</sup> The Directive states that the Commission shall adopt implementing measures further specifying the disclosure obligations of AIFM and the frequency of disclosure.

<sup>7</sup> A controlling influence is defined as an AIF which either individually or in aggregate acquires 30% or more of the voting rights of an issuer or of a non listed company domiciled in the EC or has concluded an agreement to that effect.

	Disclosure Obligations contained in the proposed EU Directive	Disclosure Obligations contained in the Walker Guidelines
<b>5 (con.)</b>	<b>Disclosure following acquisition of a controlling influence in non-listed companies and issuers (Article 27 and Article 28)<sup>7</sup></b>	<b>Responsibility at a time of significant strategic change</b>
	<p>If the holding is a <i>listed</i> company the following must be made available to the company, its shareholders and employee representatives (or where there are none, to the employees themselves):</p> <ul style="list-style-type: none"> <li>• certain information required under the Takeover Directive<sup>8</sup> - essentially all the information contained in the offer document;</li> <li>• the policy for preventing and managing conflicts of interest, in particular between the fund manager and the company; and</li> <li>• the policy for external and internal communication with stakeholders in particular as regards employees.</li> </ul>	
<b>6</b>	<b>Disclosure following a delisting (P2Ps) (Article 30)</b>	<b>Disclosure following a delisting</b>
	Where following the acquisition of the controlling influence of a listed company, the shares of that company are delisted, the company must continue to comply with its obligations under the Transparency Directive <sup>9</sup> for 2 complete financial years from the date of withdrawal from the market (annual and half yearly public accounts).	No requirement to continue with Transparency Directive obligations following a delisting.
<b>7</b>	<b>Data input by a Portfolio Company to the Industry Association</b>	<b>Data input by a Portfolio Company to the Industry Association</b>
	No requirement to provide data to an industry association.	<p>Portfolio companies should provide data for the previous calendar or accounting year on:</p> <ul style="list-style-type: none"> <li>• trading performance, including revenue and operating earnings;</li> <li>• employment;</li> <li>• capital structure;</li> <li>• investment in working and fixed capital and expenditure on R&amp;D; and</li> <li>• such other data as may be requested by the BVCA after consultation where they can be made available without imposing material further costs.</li> </ul>
<b>8</b>	<b>Data input by Private Equity Firms to the Industry Association</b>	<b>Data input by Private Equity Firms to the Industry Association</b>
	No requirement to provide data to an industry association.	<p>Private equity firms shall provide data on a confidential basis to an accounting firm appointed by the BVCA to cover:</p> <p>With respect to the previous calendar year:</p> <ul style="list-style-type: none"> <li>• the amounts raised in the funds for investment in UK portfolio companies by transaction value;</li> <li>• acquisitions and disposals of portfolio companies;</li> <li>• estimates of aggregate fee payments to other financial institutions, legal accounting, audit or other advisory services associated with establishment/management of funds; and</li> <li>• other data which may be required by BVCA for the purpose of assessment of performance on an industry-wide basis;</li> </ul> <p>With respect to exits from UK portfolio companies over at least the previous calendar year:</p> <ul style="list-style-type: none"> <li>• the returns generated by private equity.</li> </ul>

<sup>9</sup> Article 6(3) Directive 2004/25/EC

<sup>8</sup> Directive 2004/109/EC

	Disclosure Obligations contained in the proposed EU Directive	Disclosure Obligations contained in the Walker Guidelines
9	<p><b>Reporting to competent authorities (Article 21 and 24)</b></p> <p><b>Article 21</b></p> <p>AIFM shall regularly report to the competent authorities of its home Member State on the principal markets and instruments in which it trades on behalf of the AIF it manages.</p> <p>It shall provide aggregated information on the main instruments in which it is trading, markets of which it is a member or where it actively trades, and on the principal exposures and most important concentrations of each of the AIF it manages.</p> <p>For each AIF an AIFM manages, it shall periodically report to the competent authorities of its home Member State:</p> <ul style="list-style-type: none"> <li>• the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature;</li> <li>• any new arrangements for managing the liquidity of the AIF;</li> <li>• the actual risk profile of the AIF and the risk management tools employed by the AIFM to manage these risks;</li> <li>• the main categories of assets in which the AIF invested; and</li> <li>• where relevant, the use of short selling during the reporting period.</li> </ul> <p>For each of the AIF it manages the AIFM shall submit the following documents to the competent authorities of its home Member State:</p> <ul style="list-style-type: none"> <li>• an annual report of each AIF managed by the AIFM for each financial year, within four months from the end of the periods to which it relates; and</li> <li>• a detailed list of all AIF which the AIFM manages for the end of each quarter.</li> </ul> <p><b>Article 24 - disclosure to regulators of leverage used at the fund level</b></p> <p>Disclose to the regulator on a regular basis:</p> <ul style="list-style-type: none"> <li>• information about the overall level of leverage employed by each fund, with a break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives; and</li> <li>• the five largest sources of borrowed cash or securities for each of the funds and the amounts of leverage received from each of those sources for each of the funds managed by the managers.</li> </ul>	<p><b>Reporting to competent authorities</b></p> <p>No such requirement.</p>

## SAVE THE DATE

Technical Updates at the

# TAX, *Legal* and **Regulatory** Event

London 26 November 2009

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### TAX



**David Huff**

Chair – Tax Committee

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Topics likely to include:

- 1 Practical tax compliance issues for Private Equity firms
- 2 Overview of VAT issues for Private Equity firms, transactions and portfolio companies
- 3 Update on tax structuring options for funds and transactions

### LEGAL & TECHNICAL



**Sue Woodman**

Chair – Legal & Technical Committee

Alchemy Partners

Topics likely to include:

- 1 Consolidation, fund accounting and valuation issues
- 2 Carbon reduction requirements
- 3 EU Transparency and portfolio disclosure requirements

### REGULATORY



**Margaret Chamberlain**

Chair – Regulatory Committee

Travers Smith

Topics likely to include:

- 1 EC Directive on Alternative Investment Fund Managers
- 2 Regulatory updates: UK and other
- 3 Market abuse, insider dealing and confidential information

CPD Points Accreditation being sought

### Special Offer!

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