



BVCA Campaign: The Alternative Investment Fund Managers Directive

November 2009



DEALING WITH THE DIRECTIVE



As everyone involved with private equity and venture capital should know by now, the proposed European Union Alternative Investment Fund Managers Directive (AIFM) is by far the largest regulatory and political challenge that we face. If exacted in its present form, this Directive would impose substantial new costs on the sector – recently estimated in an independent assessment commissioned by the FSA to be 800 million euros in terms of the one-off expense of compliance and then some 280 million euros per annum in ongoing thereafter.

These are costs that the industry can not afford to absorb. If exacted, the Directive would make Europe a profoundly less attractive place in which to conduct private equity business. It is of absolute importance that we convince those who matter within the EU that these proposed regulations must be radically amended if serious damage is not to be done to the European economy.

Engagement occurs on two fronts. One is through the EU Council of Ministers (officials and ultimately national politicians). The other is in the European Parliament, especially the MEPs who serve on the Economic and Monetary Affairs Committee. The purpose of this document is to outline the essence of the BVCA's communications strategy to meet this challenge. It deals with basic questions such as "Why are we here?", "What have we been doing?", "What are our arguments?" and "Where are we going next?". It includes an Appendix which draws from our detailed submission to the House of Lords EU sub-committee and the media coverage we have achieved so far.

I would very much welcome any comments, thoughts or questions that you might have about the material here and our approach in the months to come.

A handwritten signature in blue ink, appearing to read "Simon Walker".

Simon Walker
Chief Executive
BVCA

Why are we here?

Although private equity has become a more important player in the European economy in the past decade, sweeping EU wide regulation of the industry was far from inevitable. Rather, it would normally be considered a sector where national governments determined independently the extent to which they wished to intervene in the operations of the market. Private equity finds itself at risk of regulation because of the combination of two factors. The first is a persistent campaign by relatively few but very prominent politicians within the European Parliament, notably Poul Nyrup Rasmussen, a former Prime Minister of Denmark who has been aggrieved at a particular private equity transaction in his home country. The second is a more general sense in the aftermath of the global economic crisis that anything associated with Anglo-Saxon capitalism should be subjected to more scrutiny in future.

The three distinguishing features of this Directive which make it so menacing are:

- It is highly political in character and content whereas conventional EU Directives are much more technical in nature.
- It was written in extreme haste to satisfy the political objective of being published before the European Parliament elections in June and was not tempered by the sort of searching impact assessment and widespread consultation which is customary with most EU Directives.
- It is deliberately one-size-fits-all in its scope. Provisions of the Directive which were plainly intended to apply to the hedge fund industry have been stretched to capture private equity and venture capital, even if that involves regulation which makes little sense to our sector.

The BVCA accepts that some new regulation will be forthcoming and that it could in certain spheres be desirable. What is dangerous is regulation which is motivated by politics not policy, cast in careless language, with stringent demands which are highly inappropriate to the industry concerned.

What have we been doing?

Since the publication of the Directive the BVCA has been actively engaged in communicating to both its members and an external audience the impact the Directive would have on the industry. Specific details are outlined below:

UK Government

The BVCA has led an extensive lobbying campaign and has worked closely with the Government, expressing the industry's concerns and providing detailed information to help the Government with their negotiations.

Highlights of the BVCA campaign include:

- The BVCA submitted a completely revised directive to the Government
- Suggestions in our revised directive were adopted in the paper submitted by the Government to the Swedish presidency, which currently holds the EU presidency, as well as in the options paper the Swedes have since produced on a way forward
- The Regulatory Committee has produced additional information - requested by the Treasury - on some key issues in the Directive, namely capital requirements, valuation and custody.

The UK government continues to be an important avenue for lobbying, particularly:

- HM Treasury – Lord Paul Myners, Financial Services Secretary to the Treasury
- FSA – Dan Waters, Head of Asset Management

On the basis that the final and most crucial stage of negotiations on the Directive may well take place after a UK general election next spring, the BVCA has started the process of liaising directly with key figures inside the Conservative Party to inform them of developments with the Directive.

Technical Committees:

- The Regulatory Committee has produced detailed analysis of the Directive, including the completely revised directive submitted to the Government in July
- In addition, the BVCA's technical committees have produced regular and timely updates to members on the scope of the Directive
- The Regulatory Committee has produced additional information - requested by the Treasury - on some key issues in the Directive, namely capital requirements, valuation and custody
- Suggestions in our revised directive were incorporated in the paper submitted by HMG to the Swedish presidency, as well as in the options paper the Swedes have since produced on a way forward.

Member Engagement and Updates:

The BVCA launched an intensive member awareness programme to ensure all members were advised of the Directive and the consequences it could have on their firm and portfolio companies. From the 22nd October 2009 members will receive bi-monthly updates, specifically on the Directive.

A Venture Capital sub-committee has been established to ensure the breadth of the membership inputs into BVCA thinking.

The BVCA is also currently recasting its website, which will host comprehensive details of the BVCA positions, updates and key concerns.

The Financial Services Authority (FSA):

- The BVCA has worked closely with the FSA and has representation on the FSA/Treasury working groups that were established to provide more detailed analysis.

Engagement with Limited Partners:

- The BVCA has sought to engage with Limited Partners. Simon Walker, BVCA Chief Executive and Simon Havers, BVCA Chairman, sent letters to LPs outlining the key threats posed by the Directive and asking them to write their own letters objecting to the Directive.
- It was noted that given the Directive was partly designed to provide investor protection, it was critical that LPs were enlisted to help strengthen the case. The BVCA also wrote a similar letter to GP's asking that they contact their LPs to make a similar request.
- The BVCA facilitated an open letter to The Times newspaper from five leading pension funds against the AIFMD.

The BVCA has also worked with other trade associations and think tanks, including:

- CBI
- Alternative Investment Management Association (the hedge fund trade association)
- British Bankers Association
- Association of British Insurers
- Policy Exchange
- Open Europe

This has resulted in a number of events and public statements questioning the necessity and logic of the Directive from the wider business community

The BVCA has of course also been working closely with EVCA in Brussels and is a permanent member of the newly created Public Affairs Executive.

The BVCA has an ongoing contact program with MPs, ministers and officials including but not limited to:

- HM Treasury – Lord Paul Myners, Financial Services Secretary to the Treasury
- BIS – Lord Mandelson, Secretary of State for Business, Innovation and Skills
- FSA – Dan Waters, Head of Asset Management
- European Commission – Charlie McCreevy, Internal Market and Services Commissioner
- Sir Gus O’Donnell, Secretary of the Cabinet and Head of the Home Civil Service
- Boris Johnson, Mayor of London
- The Conservative Party – George Osborne, Ken Clarke, Philip Hammond

The BVCA has an ongoing contact program with key media, including but not limited to:

- The Financial Times (Martin Arnold, Andrew Hill, Brooke Masters, Lionel Barber)
- The Daily Telegraph/Sunday Telegraph (Damian Reece, Helia Ebrahimi, James Quinn, James Kirkup)
- The Times/Sunday Times (David Wighton, Suzy Jagger, Peter Riddell, Helen Power)
- Evening Standard (Anthony Hilton, Chris Blackhurst)
- The Daily Mail/Mail on Sunday (Alex Brummer, Simon Watkins, Lisa Buckingham)
- The Guardian/Observer (Philip Inman, Elena Moya, Dan Roberts)
- WSJ (Simon Nixon, Dave Kansas)
- The Economist (Patrick Foulis, Tom Standage)
- City AM (Allister Heath, John Kenchington)

Contact Programme

- EU Institutions

European Parliament

The Parliament is seen as the key focus for influencing the Directive over the next few months.

The ECON committee consists of 48 members under the chairmanship of a British Liberal Democrat, Sharon Bowles MEP, who as Chairman will be very influential on the process. BVCA has met with the individuals highlighted below and we will continue this process in October and November.

**CHAIR ECON
COMMITTEE**



**Sharon Bowles,
Alde**



**Godfrey
Bloom, EFD**



**Ashley Fox,
ECR
(Substitute)**

**SHADOW
RAPPORTEUR**



**Syed
Kamall,
ECR**



**Vicky
Ford,
ECR**



**Catherine
Stihler, S&D
(Substitute)**

KEY:
Alde- Alliance of Liberals
and Democrats for Europe
(Lib Dem)

ECR- European
Conservatives &
Reformists (Con)

S&D- Socialists &
Democrats (Labour)

EFD- Europe of Freedom
and Democracy (UKIP)

VICE CHAIR



**Arlene
McCarthy,
S&D**



**Kay
Swinburne,
ECR**



**Peter
Skinner,
S&D**

Commission

There are a host of commission officials who will play a role, including:

- Commission President Barroso
- Internal Market and Services Commissioner Charlie McCreevy
- David Wright – Deputy-Director General (Financial Services), DG Internal Market and Services
- Ugo Bassi – Head of Asset Management Unit, DG Internal Market and Services

A new Commission will be established shortly (expected date November/December); its members will be key targets for ensuring our voice is heard.

- Vigorous media effort including letters, comment pieces, comment in articles in UK daily press, trade press, BBC Radio, European and international media has resulted in coverage which is almost universally sceptical on the Directive. (Key coverage can be viewed in Appendix Two)
- The BVCA has worked with the Mayor's and City of London's offices to highlight the negative impact the Directive would have on the City of London. This has resulted in a number of speeches being made by both the Mayor and Lord Mayor opposing the Directive which have generated significant media coverage.
- Since February members of the BVCA's senior executive (Simon Walker, Simon Havers and Hugh Lennon) have delivered over 40 speeches of which the AIFM Directive has been a central theme. Simon Walker spoke at all three party conferences, highlighting the damage the Directive will inflict on the industry.

Charles River Associates cost-benefit analysis of the AIFM



The BVCA has inputted into the FSA commissioned cost-benefit analysis of the AIFM, which was published in October 2009 by Charles River Associates (CRA).

This is the first genuine attempt at an economic impact assessment and the detail which is included makes it extremely credible. The analysis highlights the shocking costs that the industry would face if the Directive was implemented in its current form. Private equity and venture capital funds face the largest ongoing compliance costs of all of the different types of fund (€248 million and €33 million respectively). The principal components of the on-going costs are information reporting about portfolio companies and the mandatory use of independent “valuators” to estimate the fair value of the PE portfolio. A summary of the costs identified by CRA are outlined below: (NB 1 basis point (bp) is equal to 1/100th of a percentage point; percentages refer to total AUM managed in the EU)

	Private Equity	Venture Capital
One-off costs		
Disclosure to investors	0.0	0.0
Delegation restructuring	8.25	
Relocating / re-domiciling	19.7	19.7
Legal structures	14.1	14.1
Total one-off costs (bp)	42.1	33.8
Total one-off costs (€m)	756	45

	Private Equity	Venture Capital
Ongoing costs		
Disclosure to investors	0.0	0.0
Disclosure re portfolio companies	2.9	3.7
Delegation	0.2	
Valuator	4.3	9.2
Capital	1.5	1.9
Depository	5	10
Total ongoing costs (bp)	13.8	24.8
Total ongoing costs (€m)	248	33

The full report can be viewed at: http://www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf

Key Issues

What are our arguments?

The BVCA's key concerns focus on the following elements in the Directive.

- Capital requirements
- Disclosure
- Structural issues
- Third country funds
- Marketing

The BVCA would also like to see:

- An exclusion for closed end funds on the capital requirements
- A substantial raising of the thresholds for the disclosure elements
- A removal from scope for VC/PE funds on the structural arrangements
- A complete rewrite on the third country funds, to allow investors easy access to non EU based funds
- A substantial rewrite on the marketing elements to make both the passport open to HNWs and the requirements for national regulator approval more realistic (i.e. not to need pre-approval at each stage of activity).

The following slides set out the provisions in (and some implications of) the AIFM Directive as they relate to private equity and venture capital fund managers as currently drafted. Further details can be found in Appendix One.

Capital requirements

Fund managers to set aside additional regulatory capital. These sums will be material and as drafted are equivalent to one quarter of the manager's fixed annual overheads. In some cases that will mean dramatic increases from the current £5,000 annual requirement to around £8 million. The costs for new operations in particular are likely to be prohibitive.

Disclosure

Fund managers to disclose information on portfolio companies, including business plan. This provision will apply to all portfolio companies where the fund owns a 30% or greater stake (as drafted). The specific requirements are similar to those set out in the Walker guidelines but the number of companies affected will be far greater. There are around 54 'Walker companies', whose additional disclosure is based on their larger social footprint and rough equivalence to the FTSE 350.

The AIFM criteria will capture a far greater number of portfolio companies, probably around 500-600 in the UK alone. These provisions would not apply to competitors, where private businesses are owned by families, conglomerates, or even banks or oligarchs.

‘Structural issues’

The fund manager must appoint an independent valuator, custodian and depository. A report for the FSA concluded that the combined cost of these measures would be around 30 basis points, on an annual basis, after initial costs of over 70 basis points.

Marketing

The fund manager must notify the FSA (which will notify its EU counterpart) of any proposed fund marketing, as well as provide final form documents to the regulator, and may not alter them without first notifying the regulator; a clearly impracticable requirement.

The AIFM will grant a passport to fund managers wishing to market funds across the EU, but this marketing will be confined to ‘professional investors’. The definition of ‘professional investor’ would exclude high net worth and sophisticated individual investors – an important part of the industry’s LP mix.

Investor access and global competitiveness

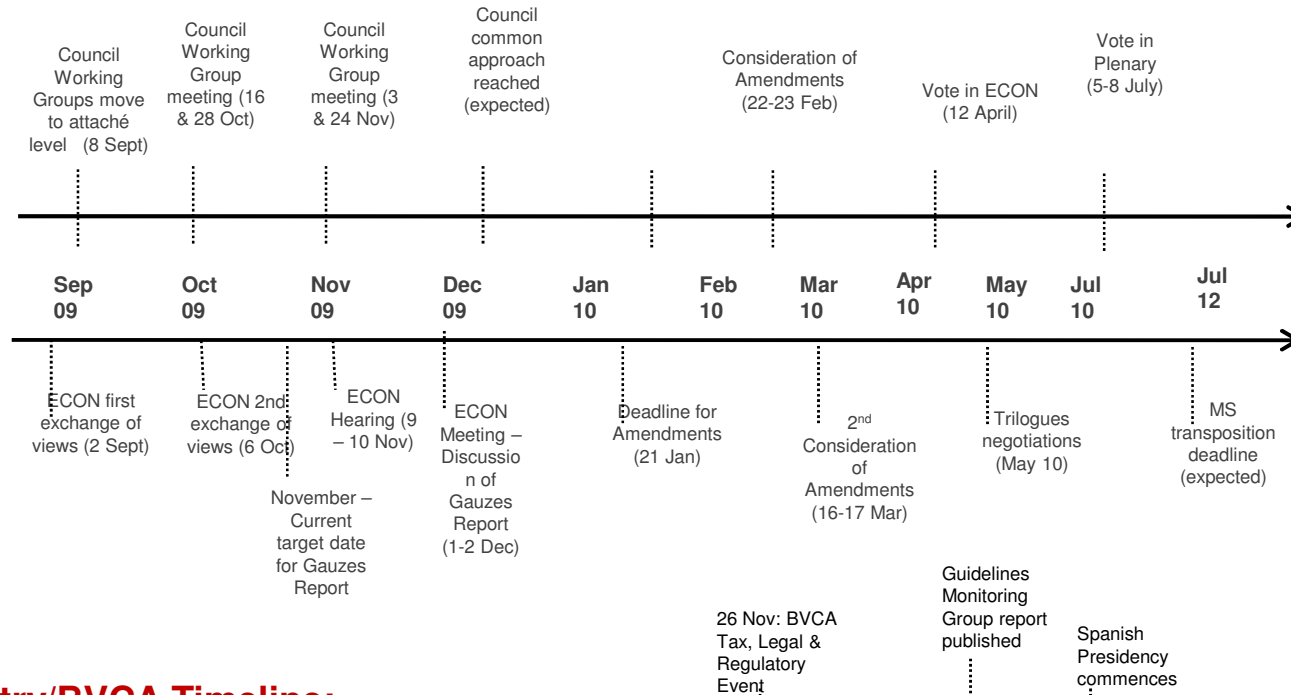
The only funds which may be marketed to European professional investors are those which have an authorisation under the Directive. To qualify for the authorisation, the fund manager must be based in the EU or in a 'third country' deemed to be an 'equivalent jurisdiction'. In practice then, the fund manager will have to be based in the EU in order to raise money from EU investors. An independent report for the FSA recently concluded that this could mean investors lose access to as much as 35% of private equity funds and 19% of venture capital funds currently available to them.

An additional risk is the possibility of retaliatory action from the US authorities. If they were to decide that only US-based funds could raise money from US investors, this would have a hugely detrimental impact on the UK industry's source of funding: around 45% of the capital raised annually by BVCA members comes directly from the US.

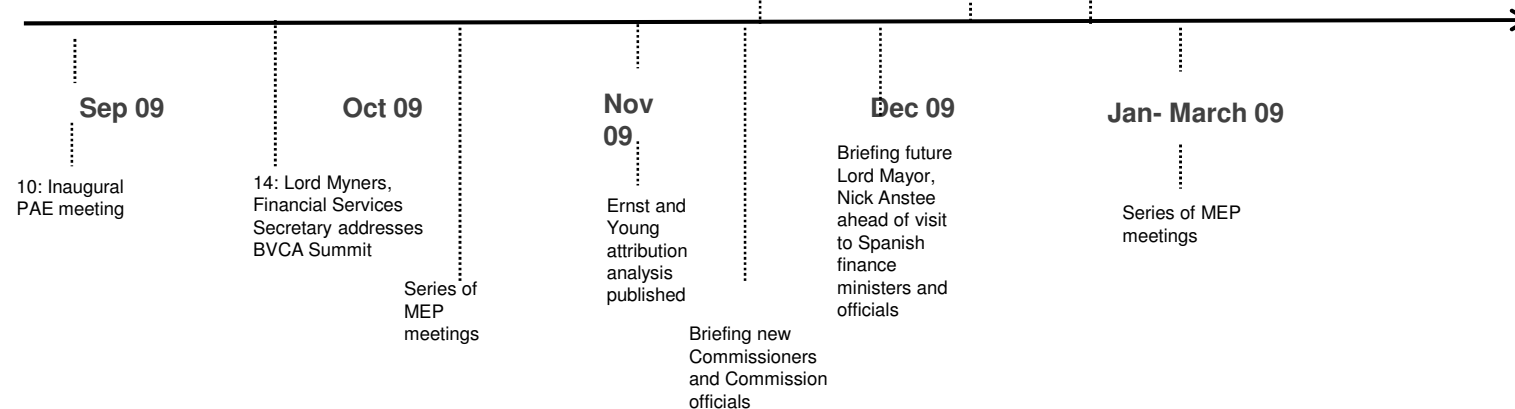
Going forward



Institutional Timeline:



Industry/BVCA Timeline:



- Raise political pressure in Whitehall to effect a more vigorous approach in Council negotiations from Treasury officials
- Inform the Conservative Party as to what it might inherit if the process continues into mid-2010 (as it is likely to).
- Focus on key MEPs as the European Parliament stage in proceedings begins in earnest.
- Focus media effort on a relatively small number of key amendments in the areas with which we are most concerned.
- Mobilise the industry as to the threat it faces through meetings, seminars, events, input from committees and regular communications from the Chief Executive.

Appendix One

(Extracted from the BVCA Headlines Paper/Submission to the House of Lords EU Sub-Committee)



CAPITAL REQUIREMENTS:

The Directive imposes capital requirements by requiring the fund manager to maintain a minimum level of *own* funds. As with the current FSA regulatory capital rules applicable to investment managers, the requirement not to hold money in a bank account, but rather that capital should be retained in the fund manager.

As a result, owners of PE and VC businesses must contribute additional shareholder capital to the management company. The requirement will usually be equal to one quarter of the manager's fixed overheads, including salaries, rent etc. (as opposed to EUR 125,000 as some mistakenly believe).

Impact: This will be a major obstacle to the establishment of new firms, new funds and innovation. In the UK, new firms are usually established by a small team of executives spinning-off from an established house. In many cases, they will struggle to capitalise their new firm. Increases will be dramatic: one established mid-market PE house estimates its owners would need an additional £8m of capital.

BVCA Response: There is no identified market failure. The light capital regime operated for many years by the FSA has not given rise to any failures because it is structured to recognise that managers of professional investor funds are different.

The fund is closed-ended, so investors cannot reduce their commitments. In addition in most cases, fund terms already provide for a break fee (usually 12-18 months' fees), which would support an orderly wind-down.

PUBLIC DISCLOSURE:

The Directive would require a PE fund with EU investors to disclose its business plan for the portfolio company to the company, its other shareholders and employee representatives or (where none exists) its employees. That information will become public.

Impact: A huge competitive disadvantage for any PE fund with European investors. Since most such funds are based in the UK, a disadvantage for the City with little or no cost to other Member States. Any other buyer of an EU company – no matter how sensitive or important – will have no such obligation. Unregulated competitors will include oligarchs, Continental banks, family offices, conglomerates, even US private equity funds which have no European investors. It is also inconsistent with EU company law and corporate governance principles for a 30% shareholder to be setting a business plan for its portfolio company (this is the function of the company's board).

BVCA Response: The BVCA believes that the disclosure of information should consistently apply to every kind of private investor. The proper vehicle would be a new Company Law Directive. In absence of that, the requirements on portfolio company disclosure should be removed. At the very least, it must be ensured that there is no requirement to disclose trade secrets or confidential information.

The disclosure requirements are entirely discriminatory with no cost-benefit justification. They are contrary to the principle of regulating by reference to economic substance, as opposed to legal form (FSA's Turner report).

STRUCTURAL ISSUES

Under the Directive, a PE fund must appoint an independent valuer and an independent custodian and may not delegate any function without the permission of the FSA on a case-by-case basis.

Impact: This will increase costs, which will be suffered by fund investors, to no benefit. The BVCA believes that private equity should be exempt from these requirements. At least in the case of custody require the manager to segregate portfolio company assets from fund assets (the MiFID standard). An independent valuer is not necessary in PE funds as fees are not based on valuations. The true value of a portfolio company is established when it is sold and it is only at that point that investors receive value. No current service provider has the skills to value the portfolio company; nor would an auditing firm, even if it were prepared to assume the liability to investors. Costs of valuation could be expected to be enormous.

BVCA Response: An independent custodian makes no sense when the fund's assets are share certificates in private companies. Cash is drawn down only when required to fund an investment and it is segregated from the manager's assets and paid into a bank account. A PE manager cannot run off with the assets. In any event requiring an EU bank as custodian is excessive; there is no reason why any properly authorised manager or third party cannot have custody, as they can for retail investors under MiFID.

The FSA's approval to each and every delegation on a case-by-case basis will be a massive cost and will create moral hazard for the regulator. It goes far beyond UCITS/ MiFID requirements.

GLOBAL COMPETITIVENESS

The provisions state that the only funds which may be marketed to professional investors in Europe are those which are managed by a European firm with an authorisation under the Directive, or which are managed by a third country firm with a marketing authorisation under the Directive. The marketing authorisation however can only be obtained if the third country is judged to be based in an 'equivalent jurisdiction'. This would place restrictions on the ability of European professional investors to invest in funds managed outside Europe.

BVCA Response: There is no rationale as to why investors should be unable to invest in attractive geographies across the world just because the fund does not have an EU manager (or its equivalent). This has the potential to have a huge impact for European investors who will be unable to implement global investment strategies. It is also discriminatory against funds, as there are no such prohibitions in relation to any other investment. These provisions will deprive EU investors of the ability to access legitimate funds and implement their investment strategies.

This measure has the potential to be extremely damaging for the UK private equity and venture capital industry. Our statistics show that the majority of investors in UK managed funds are not from the UK or the EU, indeed almost half are based in the U.S alone. In addition, there are many legitimate PE structures where there is a European adviser to a non-EU manager.

It would be very serious indeed if the US took the view that the Directive is discriminatory against their fund managers. Any reciprocal action would be a huge blow to EU foreign direct investment. UK firms might well relocate to the US, their major investor base.

The BVCA believes that instead the Directive should require disclosure to an investor that the fund is managed outside the EU, as opposed to banning professional investors from accessing those funds altogether.

MARKETING

Under the Directive, before a manager can market a fund to professional investors in its own EU State it must first provide its regulator with detailed information about each fund that it intends to market. The national regulator must in turn notify its EU counterparts of any proposed fund marketing, including any information on the AIF available to investors. It has to provide final form documents and not change them without notifying the regulator. Subject to these procedures, the manager may market the fund throughout the EU to "professional investors" (as defined in MiFID).

BVCA Response: Fund marketing is central to the ability of firms to stay in business, and the process of fund raising is highly competitive and time consuming. The Directive's requirement on notifications is totally at odds with the private placement of units in private funds.

The advantage of a marketing passport is illusory when confined to "professional investors" (as defined in MiFID). High net worth and sophisticated individuals are important investors in PE/VC funds. In the current UK regulatory environment they can be treated as 'professional'. Whilst the Directive permits Member States to market to retail investors, we do not think this is sufficient.

The BVCA believes that the notification requirement should simply be to notify the home state regulator of the fact of the proposed marketing of the fund and its manager; the quantitative test for a professional investor must be disapplied. The MiFID quantitative tests must be disapplied.

A marketing passport must be effective in order to achieve a single market and reduce costs for EU investors. It must also fit the reality of fund marketing - professional funds are often bespoke and negotiated, the marketing processes work to favour investors by giving them influence and input into the fund terms. Depriving funds of access to investment from experienced individuals makes no sense.

For links to all press cuttings, visit www.bvca.co.uk/in-europe

- **The Sunday Telegraph**, 11 October 2009 [We tell Brussels: hands off UK PLC](#)
- **The Times**, 22 September 2009 [Letters to the Editor: Venture Capital Law](#)
- **The Economist**, 19 September 2009 [Buttonwood: Alternative Reality](#)
- **Financial Times**, 30 September 2009 [Venture Capitalists “caught in crossfire”](#)
- **The Mail on Sunday**, 26 July 2009 [We’re worried EC meddlers could trigger a trade war](#)
- **Financial Times**, 29 April 2009 [Lombard: A regulatory Trojan Horse that could attack the City](#)
- **The Economist**, 4 July 2009 [Neither one thing nor the other](#)
- **The Guardian**, 16 October 2009 [Fears that EU clampdown will cost hedge funds £3bn](#)
- **City AM**, 22 September 2009 [EU rules on hedge funds will hit taxes](#)
- **The Guardian**, 30 June 2009 [City hails signs of EU thaw on private equity regulation](#)
- **The Times**, 20 July 2009 [Letters to the editor: EU Directive will hurt private equity firms](#)
- **City AM**, 3 September 2009 [Boris battles Brussels bureaucrats](#)
- **The Sunday Telegraph**, 5 July 2009 [Boris guns for EU hedge fund bill](#)
- **City AM**, 30 June 2009 [Simon Walker: EU must heed expert advice on regulation](#)