

**BVCA response to inquiry on Alternative Investment Fund Managers Directive
by House of Lords European Union Committee -
Sub-Committee A (Economic and Financial Affairs and International Trade)**

The BVCA is the representative body for private equity and venture capital in the UK. Our members range from very small venture capital houses to the largest global buyout firms. The UK accounts for some 60% of private equity activity in Europe. We focus our comments below on private equity as opposed to any other form of AIF, and use private equity to refer to the provision of equity capital covering all stages of investment.

1. What economic benefits arise from Alternative Investment Funds?

1.1 Private equity brings both capital and management skill to the businesses in which it invests.

Funds provide equity capital for companies at all stages of development, from start up to expansion capital through to large buyouts. In addition, private equity firms are active investors. Their hands-on ownership gives investee companies managerial skills to become more successful businesses.

1.2 BVCA members invest significant sums in to companies outside the UK. Over the last three years BVCA members have invested over £70bn in to companies around the world. Of this, approaching half (£32bn) was invested in to almost 700 companies in EU member states other than the UK¹.

1.3 Private equity also provides a direct economic benefit through returns to its investors. Over half of the £23bn funds raised last year came from pension, insurance and endowment funds². £4bn came from investors in other EU member states (over £3bn p.a. has been raised from this source since 2005). This is money invested on behalf of, for example, pensioners, who are receiving superior returns. Whilst last year was of course a difficult one, UK private equity continues to outperform other asset classes over the long-term: the ten-year return rate for private equity and venture capital funds stands at 15.4% against 1.2% for the FTSE all-share over the same period.

1.4 Other economic benefits from private equity are indirect, from the outperformance of its investee companies: a report conducted for the BVCA showed that, over the five years to 2006/7, on average, private equity-backed companies' sales rose by 8% p.a., compared with FTSE 100 companies (6% p.a.) and FTSE Mid-250 companies (5% p.a.); exports grew by 10% p.a., compared with a national growth rate of just 4% and corporate investment rose by 11% p.a., compared with 3% nationally. In addition R&D expenditure increased by 14% p.a., compared with the national growth of 1% p.a.³.

1.5 As a recent report by the World Economic Forum concluded, private equity companies will be best positioned to attract fresh capital to invest in illiquid markets because they have established track records of aligning the interests of general and limited partners⁴. Unlike some other forms of investment, the interests of investors and managers are aligned over the long-term: fund managers are typically significant investors in their own funds, and 'carried interest' - the profit share earned by fund managers - is only paid when the fund has made healthy realised profits for investors.

¹ BVCA Report on Investment Activity, 2008.

² BVCA Report on Investment Activity 2008.

³ The Economic Impact of Private Equity in the UK 2007 Report,

⁴ World Economic Forum: *The global economic impact of private equity report 2009*.

What risks to financial markets arise from Alternative Investment Funds?

1.6 Clearly there are risks to investors associated with investment performance, and it is possible that managers could breach their contractual and fiduciary duties to investors. However, investors into private equity funds are able to understand and mitigate those risks: they conduct extensive due diligence and negotiate bespoke contractual agreements with fund managers, usually with the benefit of sophisticated legal advice. In addition, UK managers are extensively regulated by the FSA, so further regulation to tackle these risks is unnecessary and not something investors are seeking. Importantly, these risks are not 'systemic' and do not pose a risk to financial markets per se.

1.7 One area which has received attention in respect of the perceived risks associated with private equity is leverage. Private equity – particularly at the larger end of the investment spectrum – has used debt as a central component of its deal structuring, in common with many businesses that are not owned by private equity. Debt:equity ratios were around 2:1 in some larger deals over the last few years, but these ratios are consistent with previous cycles when debt was cheap. In the late 1980s, debt:equity ratios were typically similar to those found in the period leading up to 2007. Whilst investee companies faced difficulties in that period, over their lifetime large private equity funds still managed to produce excellent overall performance (a 19% median annual return).

Market forces have of late brought leverage ratios down significantly to the point where many deals are being financed through all equity structures. We do not expect leverage ratios to return to their pre credit crunch levels for a very long time.

1.8 Moreover, even at times of high leverage, it is not possible to say that private equity poses systemic risk. In private equity, each investment stands alone, so if one individual investee company fails, that company alone falls, and cannot draw on resources from other businesses financed by the same fund. In addition:

- The ECB estimates the aggregate amount lent to private equity-backed companies represents less than 1% of European banks' assets
- Total Private Equity/Venture Capital investments in 2007 account for just 0.584% of EU GDP
- No other proposals on regulatory reform of alternative investments has recommended substantial additional regulation for private equity. This includes reviews conducted by Lord Turner and Jacques de Larosiere, as well as the last communiqué from the G20. Proposals for reform in the US are considerably less onerous than what is contained in the AIFM directive.
- The Commission's own explanatory memorandum to the directive notes that private equity "*did not contribute to increase macro-prudential risks*".

Even if there were some justification to regulate leverage at the company level, it would be completely inappropriate to do so by regulating funds themselves (see 'regulatory aspects', below). If it is felt that more regulation is needed to prevent companies from taking on excessive debt, then that should be a matter for company law (and therefore apply to all companies and not just those owned by a private equity fund), or the prudential regulation of banks.

Will the Directive help reduce these risks?

1.9 The Directive provides no real means to mitigate any identified risks for private equity funds. As a recent set of guidelines drawn up by institutional investors shows, investor protection concerns centre on governance and transparency levels between investors ('LPs') and funds

(‘GPs’)⁵. The guideline’s recommendations bear no resemblance to the investor protection elements of the AIFM.

2. To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union?

2.1 We support appropriate and proportionate regulation on a national and international level, and we support the proposal in the Directive to create a pan-European passport for investment fund managers (although see comments on the current proposal below). The problem with the draft Directive as it stands is that it creates considerable unjustified burdens for private equity funds which in our opinion would be very damaging for the wider economy. We are not against regulation, and indeed are extensively regulated by the FSA - it is inappropriate and disproportionate regulation which we are against.

3. Is the Directive proportionate given the role of AIF in the financial crisis? Will the Directive introduce over-stringent regulations or does it not go far enough?

3.1 Our clear view is that the directive does not offer a proportionate response to any identified risks.

4. Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment?

4.1 We do not believe it is appropriate to regulate alternative funds as opposed managers, particularly if access to them is restricted to ‘professional investors’. These types of investors are sophisticated and therefore do not need to be protected by detailed regulation of the fund itself. Indeed the FSA currently regulates the fund manager rather than the fund for this reason. This of course contrasts with the widely accepted position that retail funds (ie UCITS funds) which are capable of being marketed to the general public need themselves to be regulated so that a degree of investor protection is built into the design of such products. Regulating alternative investment funds would stifle product innovation, would be disproportionate and indeed not feasible in practice.

4.2 The Directive does not contain sufficient differentiation between alternative assets. The AIFM covers all alternative investments and, for the most part, applies to them each equally. The BVCA would like to see private equity more clearly distinguished, so as to be able to tailor the provisions in a way which is applicable and proportionate. For example, there are provisions in the directive which relate to investors’ redemption rights, but in private equity funds, no such rights exist.

5. What is your evaluation of the Commission’s consultation in the preparation of the Directive?

5.1 The BVCA does not believe any substantive consultation was conducted before the directive was published and that the regulation suffers as a result.

Regulatory aspects: Qs 6-8

6. Will the passport system help create a single market in investments funds within the EU?

6.1 The Directive makes it a requirement that UK private equity firms must notify the FSA, which must in turn notify its EU counterparts, of any proposed fund marketing, and 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 per MiFID).

⁵ *Private Equity Principles*, Institutional Limited Partners Association:
<http://www.ilpa.org/files/ILPA%20Private%20Equity%20Principles.pdf>

- 6.2 The requirement on notifications is totally at odds with the private placement of units in funds. Fund documents are simply not in final form before marketing commences because they are by definition negotiated in the course of the fund raising.
- 6.3 The advantage of a 'marketing passport' is somewhat illusory when confined to "professional investors" (as defined in MiFID). High net worth and sophisticated individual investors are important investors in private equity funds. In the current UK regulatory environment they can be treated as 'professional'. Under the MiFID test such individuals can only be treated as such if they satisfy certain specified tests: one of which is the need to have invested in 10 funds (or possibly private equity transactions) a quarter for the previous four quarters. No one does this.
- 6.4 The Directive makes it very difficult for non-UK (e.g. US) firms to market their funds to UK (and EU) investors, substantially reducing the investment options for pension funds and insurers who currently invest. Some UK based private equity firms use a UK fund structure and others typically use a Channel Islands fund structure. Investors are perfectly happy with this. Yet the Directive introduces significant regulatory differences between these structures, the effect of which would be to impose significant additional barriers to promoting Channel Islands based funds to investors in the UK/EU. Last year, around 40% of funds raised by BVCA members came from within the EU.
- 6.5 This is discriminatory against alternative investment funds (no other investment is subject to such restrictions) and limits the investment strategy of investors. Saying that an investor cannot access funds in certain geographies is both protectionist and counter-productive.
- 6.6 We believe 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 and the quantitative test for a professional investor must be disapplied. The MiFID quantitative tests must also be disapplied.
- 6.7 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 this access makes no sense.

7. Is the threshold for defining "systemically relevant" Alternative Investment Funds appropriate?

- 7.1 The BVCA believes the threshold for inclusion of private equity funds under management of EUR500m is too low. It would catch a number of venture capital, early stage and small and mid market buyout fund managers who are making quite small individual investments. As noted above, no private equity fund poses systemic risk, even one that makes large investments.

Should the Directive include provisions on capital requirements?

- 7.2 Capital requirements make sense for deposit taking and other financial institutions where increasing the amount of capital set aside increases investor protection. This is not the case for private equity.
- 7.3 The Directive requires owners of private equity businesses to contribute additional shareholder capital to the management company, which will usually be equal to ¼ of the manager's fixed overheads, including salaries, rent etc. (as opposed to EUR 125,000 as some mistakenly believe). Capital requirements are not relevant for private equity as they offer no additional investor protection. Unlike other alternative assets, in a private equity fund there are no redemption rights for investors. Equally, there is no identified market failure. The much more proportionate

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.

7.4 Increases in capital required to be set aside will be dramatic: one established mid-market PE house estimates its owners would need an additional £8m of capital. In addition, 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. It will also reduce the amount available for investing by the manager on the same terms as the investor, a very helpful way of more closely aligning interests between the two.

7.5 A more sensible way to proceed would be to carve out those closed end funds where there are no redemption rights, and then to focus on professional indemnity insurance as the appropriate mechanism for addressing investor protection.

Does the Directive contain appropriate rules on leverage?

7.6 The Directive contains provisions limiting the amount of leverage at fund level. Private equity borrows at the level of the investee company rather than at fund level, so this proposal should not impact private equity funds. However, more clarity is needed to make this clear.

Is the requirement for independent valuation agents and depositaries for Alternative Investment Funds adequate?

7.7 The Directive requires that a fund must appoint an independent valuer and an independent custodian and may not delegate any function without the FSA permission on a case-by-case basis. The associated increased costs will be suffered by fund investors, to no benefit.

7.8 An independent valuer is not necessary in PE funds as investors do not subscribe or redeem at net asset value. The true value of a portfolio company is established when it is sold and only at that point do investors receive value. Interim valuations have no purpose, save to provide information. Costs of valuation could be expected to be very significant.

7.9 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 is excessive, there is no reason why a properly authorised manager or third party cannot have custody, as they can for retail investors under MiFID. The FSA has for years regulated private equity managers for the provision of custody services to their funds.

7.10 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. We would suggest removing private equity from these requirements. Or in the case of custody, require the manager to segregate the assets from its own assets (the MiFID standard).

8. Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

8.1 A private equity fund with EU investors will be required to disclose its business plan for its portfolio companies to the company, its other shareholders and employee representatives or (where none exists) its employees. That information will therefore become public. We estimate that these requirements will cover 500-600 UK based private equity portfolio companies (as well as many more across the EU). This compares with around 6,000 UK based privately owned companies of a similar size who will not be subject to these requirements.

- 8.2 This would be a huge competitive disadvantage for any private equity funds with EU investors. Any other buyer of an EU company will have no such obligation. Competitors will include oligarchs, Continental banks, 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.
- 8.3 The proper vehicle for this issue would be a new company law directive which takes in all forms of private investment. In the absence of that, a regime similar in scope to that drawn up by Sir David Walker in 2007 would be a more realistic way forward. The Walker regime currently takes in 16 buyout houses (with another 16 volunteers), most relatively large and organisationally and financially able to cope with the disclosure requirements for the 54 companies covered. The portfolio investment criterion cover 80% of UK buyout activity, roughly equating to the FTSE 350.

Impact: Questions 9-11

What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? What effect will the Directive have on flows of capital and financial innovation? How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the US?

- 9.1 The Directive has the potential to drive investment away not just the UK, but from the EU a whole. The provisions, particularly the inability of non EU funds to raise money in Europe, could well mean funds look to base themselves in jurisdictions without such restrictions. Around 40% of funds raised by BVCA members annually comes from within the EU. Many of our members are, however, based outside the EU. Any retaliatory measure from the US could also have a dramatic impact on capital flows: around 45% of funds raised annually come from the US (with a further 14% coming from Asia and the Middle East).
- 9.2 The logical result of this is that the scale of private equity investment in the EU will reduce. This would have a greater impact on the UK given the preponderance of private equity investment from the UK. Some estimates put private equity's uninvested capital (or 'dry powder') at almost \$1trillion⁶. The AIFM as drafted would ultimately mean less of this is invested in to EU businesses, many of whom are struggling in the downturn.
- 9.3 As drafted, the directive already captures around a dozen pure venture capital funds (and any threshold reduction would clearly bring in more). These funds are making investments in to highly innovative businesses, in areas like cleantech, bio science, digital and advanced manufacturing. Any threat to the funding of these businesses would have negative consequences, not just for these companies, but for the next generation of innovation.
- 9.4 The US is currently debating proposals on the regulation of alternative investment funds (including private equity). So far these look markedly less onerous than what is proposed under the AIFM, focusing on registration with relevant authorities the creation an oversight council for financial services. This would make the US a comparatively more attractive jurisdiction in which to base a fund, and it is also hard to see how funds based in the US would meet the 'equivalence' test set out in the Directive which would allow them to market in the EU.

⁶ Prequin.