

On behalf of the Public Affairs Executive (PAE) of the *EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY*

6 October 2009

Note on Fund Governance and Advisers

The question has arisen as to whether or not the Alternative Investment Fund Managers Directive should apply to an "adviser" or be restricted only to a "manager". In considering this question it is important to determine (i) what is meant by an "adviser" and (ii) whether the aims of the Directive are best met by applying it to advisers. These questions need to be asked across the range of types of alternative investment strategies which will be covered by the Directive. This paper focuses on answering these questions in relation to venture capital/private equity.

We should note as a preliminary point that whatever conclusions are reached on the scope of the Directive we consider it very important that there should be only one AIFM for each AIF. We do not believe it would be either practical or desirable in terms of regulation or governance to have more than one entity with the ultimate responsibilities for an AIF under the Directive.

What is an adviser?

There is no single structure for private equity funds. Similarly, there is no single standard structure for the operation of or supply of services to these funds. The detail of fund governance structures will vary depending on amongst other things the jurisdiction of the investor base, whether this is national or international, the location of investment activity and the place of establishment of the fund and of those providing services to it. In the same way, there is no single industry wide definition of an "adviser". However there are some activities which advisers typically would not do and some activities which an adviser typically would.

Services which an adviser would not perform

Decisions on fund investments and divestments are normally taken by a fund manager, by the general partner of the fund (if structured as a limited partnership with a managing general partner or a special (managing) limited partner), or by the fund itself (if the fund is structured as a company). The functions of agreeing the terms of the fund with investors, investment risk management and administering the fund may be performed by one or more of these entities or by additional entities. An Investor Advisory Committee comprising investor representatives is typically established to advise one or more of these entities on conflicts of interest.

Typically an "adviser" will not perform any of these roles.

A hallmark of any adviser will often be that it does not have decision making powers,. We should note that slightly different terminology is used in the US where the term "advisor" may be used to cover those with discretionary investment management powers. However that is not the case in Europe.

Services which an adviser might perform

One or more advisers may be appointed to supply a range of services to the fund and the associated entities described above. It would be typical for an adviser to perform one or more of the roles listed below. Some advisers will perform all of these roles; many will perform only one or two (sometimes only for a particular transaction):

- a) provide a regular service of identifying potentially attractive investments in the geographical area for which the adviser has responsibility, organize and coordinate due diligence, make recommendations about investment, assist in negotiations and assist in procuring the investment for the fund;
- b) provide the above service on an occasional basis;
- c) provide specialist advice on an occasional basis about a particular sector or investment;
- d) assist in answering investor queries about the activities of the adviser;
- e) assist in promoting the next fund to potential investors in the geographical area for which the adviser has responsibility;
- f) assist in monitoring investments which it had recommended.

Acting as shareholder the AIF may also elect or nominate a non-executive director of an investee company (e.g. supervisory board members). In addition to the above advisory roles, a fund will require legal and accounting advice in relation to specific transactions and may make use of other types of advisory or consultancy services. We assume that the services of such lawyers, accountants, directors and consultants are outside of the intended scope of the Directive.

Location of adviser

An adviser is typically based in a different Member State from the fund/manager/administrator (which may or may not be located in a third country). A structure may have multiple advisers. For example, a global fund management firm could be based in the US and have local advisory entities in Member States and in a number of third countries in other continents. Similarly, an EU based fund/manager structure may have one or more advisers based in third countries and other Member States. Alternatively, there may be only one adviser in the entire structure, which could be located within a Member State or one adviser may have a number of sub-advisers for different areas or sectors. There are therefore a number of fund structures in existence which have advisers within the overall structure. Some, but not all of these, will be funds which are established in third countries which are managed by third country managers.

Tax risk for investors

Investors in AIFs encourage AIFs to be structured so as to ensure transparency from a tax perspective. This is in order to ensure that any proceeds generated by their investment in the fund will be correctly taxed only in their own jurisdictions in the same way as if they had invested directly and consequently that there will be no tax charged at the fund level. The structuring of the AIFs is particularly important for the significant part of the private equity and venture capital investor base which is tax exempt in their respective home jurisdictions such as pension funds, university endowments etc.

Application of the Directive

The adviser would not be "the key decision maker with access to all relevant information directly responsible for risk management and relations with investors" (see Commission Staff Working Document Impact Assessment). Page 30 of the impact assessment sets out the objectives of the Directive. We consider below whether it is appropriate to apply the Directive to advisers in light of these objectives and the operative provisions of the Directive designed to meet them:

- a) *All AIFM to be subject to appropriate authorisation and registration.* This does not provide guidance on whether an adviser should be an AIFM.
- b) *Proper monitoring of risks.* An adviser will typically have information only about the transactions on which it advises. This will typically not reflect the entire portfolio of the AIFM (for example a fund will often have an adviser in each country where investments are contemplated and so the adviser will only have knowledge about the portfolio in such country which falls within its scope). The adviser may not have the information required to make the reports required in the Directive in order to meet this objective. In relation to other asset classes, where the adviser does not have decision making authority in relation to the fund, it would in our view be more appropriate to apply registration and disclosure requirements to a fund manager than to an adviser.
- c) *Common approach to protect investors.* This is achieved in the Directive through imposing on the AIFM obligations in relation to investment risk management, valuation of the AIF and its investments, safekeeping of the AIF's investments and management of conflicts of interests between the AIF and the AIFM. An adviser typically does not have power over any of these matters; they are all determined by the fund/administrator/manager entities (which, since they have decision making powers and engage the adviser, can also ensure alignment of the adviser's interests with those of investors and control and monitor any conflicts the adviser may be subject to). Accordingly it would be inappropriate to apply these requirements in their current form to an adviser.
- d) *Greater accountability for controlling stakes in companies.* It is typically the fund/manager which exercises control over the investments of the fund. The adviser has no role at all on investments where it has not acted as the adviser. Where it has advised on an investment, its role varies but is typically limited to mere monitoring and stops short of control over the interest.
- e) *Develop the single market in AIF.* If advisers are not registered as AIFM and no other entity associated with the AIF is registered in the Community as an AIFM, the passporting rights in the Directive will not apply to marketing the AIF unless the third country meets the equivalence requirements. This would mean that where a third country fund has an EU based adviser which carries out both the marketing activity to European investors, and which finds and advises on European transactions, the adviser would have no status under the AIFM and the fund would be treated in the same way as a fund that has no European adviser. This would limit the success of the Directive in enhancing the single market. We would suggest that where a third country fund does have an European adviser, that it should be possible for that adviser to "sponsor" the fund, thereby providing appropriate reassurance to European investors and authorities about the management of the fund, without itself having or being deemed or purporting to have that responsibility for management, contrary to the facts of the case. We consider below how this might operate.
- f) *The requirements must be proportionate to the risks.* It is important that whether advisers are "in" or "out", the Directive does not operate in a way which has the effect of preventing them from carrying on business (or imposing significant barriers to this) at the expense of investors.

Adviser as "sponsor"

Under this structure, the Directive would facilitate the marketing of third country funds where there is an adviser in the European Union which is authorised under either MiFID or otherwise appropriately authorised in the EU who is prepared to take responsibility to EU investors and to a Member State competent authority for ensuring that the fund meets certain criteria and for procuring that certain information is made available. This approach would have some similarity with certifications which regulated firms are able to give one another in relation to anti-money laundering checks and with the treatment of data protection obligations when data is moved across national boundaries. We suggest that those criteria should be that:

- the EU adviser is responsible within Europe for the content of all marketing documentation used within Europe and for procuring that such documentation meets any standards prescribed by MiFID/AIFMD;
- investors receive from the manager information of the kind referred to in article 20 and 23;
- the EU adviser is satisfied that the organisational and administrative arrangements of the manager are designed to prevent conflicts of interest from adversely affecting the interests of the fund and its investors;
- the fund manager has appropriate risk management systems in order to monitor the risks associated with its investment strategies;
- there are appropriate procedures (where the fund is open ended) for valuations;
- the AIF complies with disclosure requirements applicable to its investments in EU companies;
- the arrangements under which the money or instruments belonging to the fund are kept are designed to segregate the assets of the fund from the assets of the manager and that where this is not possible or where there are other risk factors, that this is clearly and prominently explained to prospective investors.

Please note that this would involve a change to the activities currently performed by advisers in the EU and necessitate the entry into specific agreements with the fund manager/AIF relating to the relevant matters. Such an adviser would obtain a specific status of a “registered sponsor”. For this reason we consider that these requirements must be applied only to advisers who wish to market an AIF within the EU under the AIFMD and apply to become a “registered sponsor”.

The result of this change is that there would be four types of AIF for marketing purposes under the AIFMD:

- AIF which are managed by AIFM falling entirely outside the scope of the Directive;
- AIF which are managed by EU AIFM which are subject to the Directive;
- AIF managed by third country AIFM which meet the equivalence criteria subject to the full provisions of the Directive in relation to fund managers/funds established in third countries;
- AIF managed by third country AIFM with a European associate/adviser who is permitted to market or arrange the marketing of the AIF provided that they assume the role of a “registered sponsor” and take responsibility for procuring certain matters as described above.

We think that if advisers are to have any role within the Directive, that this may be an appropriate approach, as, above all, it is essential that there must not be more than one entity with AIFM status (or similar) in relation to any particular fund.

Application of MiFID

We note that some jurisdictions treat some types of advisers as subject to MiFID or otherwise require them to be authorised. We understand that the Directive would make no changes to this position. We note that MiFID excludes from its scope situations where an adviser (or another MiFID investment firm) only provides services to a member of its corporate group, and also in relation to employee schemes, and that there are currently no such exclusions in the Directive but, whatever conclusions are reached on the treatment of advisers, similar exclusions will need to be created for the AIFMD except to the extent that an adviser to a group company applies to become a registered sponsor.

Notes to the Editor

About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About EVCA

The European Private Equity and Venture Capital Association is the voice of European private equity and venture capital, representing more than 1,300 members. In addition to promoting the industry among key stakeholders, such as institutional investors, entrepreneurs and employee representatives, EVCA develops professional standards, research reports and holds professional training and networking events.

