

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

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Potential consequences of the measures relating to third countries set out in the proposed AIFM Directive

The proposed Directive on Alternative Investment Fund Managers (AIFM), published by the Commission in April 2009, aims at creating a framework for all Alternative Investment Funds (AIFs) including venture capital and private equity. With this proposal the Commission aims to achieve several objectives, such as improved stability in the financial system, increasing investor protection, and creating an EU internal market for AIFMs and AIFs. The private equity industry agrees with these objectives and on the principle of European regulation to reach them.

However, the provisions of the draft Directive in relation to third countries do not achieve those objectives (see Section 1 below). To create an EU internal market for AIFMs and AIFs, the development of a system based on reasonable equivalence and on tax transparency is necessary (Section 2).

1. Problems contained in the current drafting of the proposed Directive

The provisions of the draft Directive in relation to third countries (Art. 35 to 39) set forth a restrictive regime subject to mutual recognition. This mutual recognition is designed strictly, on the basis of detailed rules and not in light of the concern of achieving the objectives defined by the Commission itself or of making the cooperation between regulators more effective.

According to this proposed regime, the objectives pursued would never be achieved. Moreover, by restricting free of movement of the capital beyond what is necessary, these measures would be harmful to the financing of economic growth and innovation in the EU and to risk management by European investors.

Firstly, ***imposing additional constraints on non-EU AIFMs would reduce the pool of capital available for investment in European companies.*** This constitutes a major economic policy issue in an environment where corporate access to capital is difficult.

- Under the draft Directive (Art. 39), in order to market a fund to EU investors, an AIFM based in a third-country would have to be approved not only by the Commission but also by the supervisor of each Member State.
- Third-country AIFMs investing within the EU usually choose to have Europeans among their investors, which would be harder.
- Over the five last years, third-country AIFMs invested USD589 billion in the EU, including nearly USD50 billion in 2008 by private equity AIFMs. The annual investment under threat amounts to €30-50 billion from private equity AIFMs going forward.

Secondly, ***the freedom of European investors to invest in AIFs outside the EU would be restricted and the competitiveness of the European private equity industry vis-à-vis its North-American and Asian equivalents would be threatened.*** The EU would be “closed” from the inside as well as from the outside.

- An EU AIFM would be able to market a third-country AIF in Europe only if the prudential regulation and supervision of the AIF home-country are approved not only by the Commission

but also by the supervisor of each Member State (Art. 35). Also, the Commission could deprive EU investors in AIFs of investment opportunities in attractive third-country AIFs, inhibiting both their investment returns and their diversification strategies.

- Any type of third-country investment is affected, whether resulting from active marketing or from passive marketing (e.g. at the initiative of the EU investor), since the definition of marketing covers any general offering or placement of units or shares in an AIF "*regardless of at whose initiative the offer or placement takes place*".
- Assets of EU AIFMs invested in third countries through private equity amount to USD381 billion. The annual investment from private equity under threat going forward also amounts to €30-50 billion:
 - by reducing the investment freedom of EU investors, including pension funds and insurance companies, the draft Directive would in fact increase their risk exposure; and
 - by limiting investment in the underlying healthy and dynamic companies or projects because they are located or managed in third countries, the draft Directive would disadvantage not only EU institutional investors, but more broadly the EU economy for investment in emerging markets.

Thirdly, the supervision of the financing of the European economy will not be made easier:

- Third-country AIFMs managing third-country AIFs would not be subject to the new rules, and would remain free to invest within the EU, as long as they do not include Europeans among their investors.
- For those already active within the EU and unwilling to reduce their investments, there would be a huge incentive to exclude European investors from their funds, in order to escape the restrictions imposed by the draft Directive. In other words, these funds, which are the most suspect according to the Commission, would be less supervised than before.
- Furthermore, third countries could easily take retaliatory measures if their domestic AIFMs were banned from marketing their funds in the EU in spite of the existence of prudential regulation and supervision and of cooperation between regulators.

De facto, the draft Directive would create a situation where the proposed requirements would be unachievable, even for funds as familiar and regulated as US funds. This would be the case even though US funds obey strict professional rules, have effective governance and are subject to regulation by the SEC. The same applies for European funds with managers based and regulated in the Channel Islands which would be considered as third country AIFM under the Draft Directive.

In parallel, the "European passport" could be automatically granted to funds based in Member States with little experience in the field of financial regulation, whose recently created supervisors weigh not much, and that have already proved to be aggressive as regards tax and regulatory competition. This situation would appear to be a complete paradox.

2. The development of a system based on reasonable equivalence and tax transparency is the only way to create an EU internal market for AIFMs and AIFs

Given the current crisis, the effectiveness of cooperation between financial regulators must be the main concern. This objective would be pushed in the background by the workload involved by the adoption of the draft Directive or by the enforcement of the current legal schemes of Member States. Indeed, this would imply the renegotiation of innumerable bilateral tax conventions between Member States and third countries or the combination of regimes specific to each Member State. Maintaining those national regimes may constitute an easy solution in the short term and a safety net for third countries unable to reach EU standards, but it is certainly not the best solution in the long run with regard to the European interest.

The only way to create an EU internal market for AIFMs and AIFs is the development of a system based on reasonable equivalence with third countries in conjunction with the free movement of capital as guaranteed by the EC Treaty.

This option is preferable, firstly, for **economic efficiency reasons**: such a regime would retain for EU investors the possibility of investing in high potential companies or projects located or managed in third countries. In parallel, EU companies would remain attractive for external capital, and non-EU investors would be submitted to only one EU equivalence process, which would be proportioned with the risks they really imply, instead of complying with as many requirements as Member States.

Secondly, in a broader perspective, this system based on reasonable equivalence with third countries would **put the EU in a position to take on the role of a global financial regulator**. If some third countries agree with the EU regulatory framework for AIFMs and AIFs, and guarantee that their level of supervision is equivalent, this convergence should be validated and legally enforced. This system would allow third countries able to reach EU standards to benefit from some of the advantages of the EU internal market, while reinforcing the European model by making it both more attractive and more competitive.

On the contrary, no equivalence, would mean that no particular incentive will be given at all at EU level to third countries or areas representing a particular interest for the EU industry and economy, sharing EU objectives on supervision, and willing to engage in discussion on equivalence and exchange of information, like the US or European places, compared to off-shore centers elsewhere in the world which do not have the same level of proximity with EU. The latter would benefit in cases where some EU AIFMs would choose to move off-shore in order to escape from the regulation. This situation would appear to be a complete paradox.

Finally, this system would play the role of a **remedy or a safety net**, should inconsistency increase between the member states or a protectionist temptation rise in national regimes. It would offer the legal certainty demanded by long term investment.

As regards taxation, if its principle is obvious, its implementation should not be an obstacle to private equity and the investments it carries within the EU. Most funds gather investors from various jurisdictions, whether Member States or third countries. The issue of tax transparency for funds is essential to avoid a penalizing double taxation of all investors, both in the country of registration or management of the AIF, and in the home-country of investors. This is also the reason why several EU based AIF have their managers based in e.g. the Channel Islands which provide such required tax transparency and legal certainty thereof. In this respect, all experts agree with the ECB¹ in stressing that the absence of tax transparency for funds at the European level constitutes a restriction on cross-border investment.

In fine, the requirements of the draft Directive in relation to third countries are based on a deep unawareness of the role of private equity in the financing of the economy. EU companies need capital to grow and long term shareholders which can commit themselves to their daily management with the determination to develop an effective corporate strategy.

Regulating AIFs in the EU is an obvious need, but it should not develop at the expense of European companies. This is why such regulation should comply with the requirements of G20 and should not be based on the confusion between long term investors, such as private equity funds, and more speculative investors.

Consequently, the private equity industry, whilst accepting to maintain the national regimes, requests the amendment of the draft Directive and the introduction of a system whereby non-EU AIFMs could obtain an European passport when they are covered by an agreement between supervisors on mutual recognition or equivalence. Such equivalence must be effective EU-wide, designed according to the objectives of regulation and subject to agreement on information exchanges between the regulator of the country of origin and the EU regulators.

¹ Opinion of the European Central Bank, 16 October 2009, on the AIFM Directive (http://www.ecb.int/ecb/legal/pdf/en_con_2009_81_f_sign.pdf)

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.

