



Regulatory flak hits EU private equity

A hostile interest in the wrong industry at the wrong time for the wrong reasons?

By Peter Bartram | CFO UK | Published 13:46, 08 November 10

Chief financial officers working for Europe's 1,700 private equity firms don't know whether to laugh or cry. Their emotions have been stirred by the final draft of the Alternative Investment Fund Managers' Directive (AIFMD), a complex slice of EU legislation, which has just been agreed after one of the bitterest continental wrangles since Margaret Thatcher handbagged eurocrats over a rebate on Britain's financial contributions. Last year, when the directive was first tabled, it looked as though the party was over for Europe's burgeoning private equity industry, which invested €29 billion (£25 billion) in 5,046 companies in 2009. "At the outset of this process, a faction in the European Parliament explicitly sought to place a regulatory ball and chain on private equity and venture capital with the objective of all but destroying it, regardless of the consequences for employment and pension funds across the EU," says tough-talking Simon Walker, chief executive of the British Venture Capital Association (BVCA). "As late as this summer, it looked as if they might have found enough key allies within the member states of the EU to succeed in this misguided ambition," Walker adds. But the industry, through its trade associations, the UK's BVCA and its continental cousin, the European Private Equity & Venture Capital Association (EVCA), mounted a lobbying campaign, rated as one of the toughest and most effective ever seen in Brussels and Strasbourg. They didn't get everything they wanted, but Walker grudgingly admits that the directive "is, in a number of respects, a major improvement on what might have been". He adds: "In a series of sensitive areas, radicals within the

European Parliament have been obliged to trade substance for symbolism.” **Regulatory creep** So what has all the fuss been about? The private equity industry (as well as hedge funds and others offering “alternative investments”) are not unreasonably miffed that they’re collecting a lot of the regulatory flak which is a fall-out from the credit crunch. The EU agreed, following discussions with the G20 nations, to introduce wider-ranging regulations across many financial areas, including banking. But when it comes to private equity, the industry claims that the AIFMD is not hitting the right targets. As Walker points out: “The EU has taken a hostile interest in the wrong industry at the wrong time for the wrong reasons. No serious analyst has concluded that private equity - let alone venture capital – caused the economic crisis or served to enhance it.” Even so, governments around the world, faced with clearing up the mess, are not in much of a mood to listen to special pleading. So the directive includes a raft of new rules designed, at least, to make private equity seem a safer haven for investors’ funds. For example, general partners who control the funds will now have to make sure that cash and securities are lodged with a depositary. The depositary – probably a bank, but possibly a lawyer – has to be responsible to the fund and its investors for the loss of any financial instruments it holds for the fund. As the private equity industry points out, this is just the kind of provision which is more suitable for funds trading short-term securities unlike their longer-term funds. **Bone of contention** “Imposing rules intended to cover short-term securities trading on private equity, venture capital and other closed-ended funds investing in the real economy has proved illogical,” says Uli Fricke, chairwomen of the EVCA. “We call on policy-makers and regulators, both at EU and national level, to acknowledge the importance of drawing such distinctions in implementing the directive.” Fricke has a point. Depending on how this and other rules are interpreted when they’re implemented, European private equity funds could be looking at compliance costs rising by more than 30 percent, according to one survey. However, the main bone of contention in the directive is how private equity funds based outside the EU can be marketed inside Europe. Over the years, Jersey and Guernsey, in particular, have built up significant private equity industries. Now they are subject to rules which mean their fund managers need a “passport” before their funds can be marketed inside the EU. Details on how the passports will work and the detailed timing are still due to be worked out. But it is already clear that fund managers outside the EU need to jump through a series of hoops before they can gain the coveted passport. For example, they must appoint a legal representative inside the EU. They will get turned down if there is no agreement between their own regulatory regime and the EU or if they come from a country that is black-listed by the OECD’s Financial Action Task Force, which cracks down on money laundering. **Benefits for some** One group rubbing their hands in all of this are the specialist companies that provide administration services for private equity firms. At the moment, only a minority of general partners outsource administration. When the directive comes into play, more are likely to follow suit as administration becomes more complex and costly. “Now that the dust seems to be settling, the industry is accepting that the directive will, if nothing else, increase procedural complexity, administrative oversight and, inevitably, costs,” says Paul Everitt, managing director of Fund Corporation, a fund administrator based in Guernsey. Yet although the directive will be a done deal when the European Parliament has its final vote on 10 November, there will then be a lengthy and complex process as individual countries incorporate it into their national legislation. There is still plenty of room for more argument before all the details are decided. “There are many sections in the directive’s text which are ambiguous, inconsistent or incoherent,” says Walker. “This

means the detailed procedure for translating them into national law becomes unusually important.” The private equity business is anxious that, despite its flaws, the directive should not stunt its growth. “Europe’s private equity and venture capital is a relatively young industry and yet it has become an important contributor to investment into EU companies and innovation, and corporate governance best practice,” says Fricke. The risk, as Walker sees it, is that too much regulation could actively discourage private equity investment, which wouldn’t help economic recovery. “Private equity and venture capital stand ready to play a powerful and positive role in Europe’s economic future. The question remains whether the EU wants this to occur.”