BVCA

9 May 2012

Mr Sameen Farouk
AIFMD Transposition
Financial Regulation and Markets
HM Treasury
1 Horse Guards Parade
SW1A 2HQ

By email: aifmd@hmtreasury.gsi.gov.uk

Dear Mr Farouk,

Re: BVCA Regulatory Committee response to HM Treasury Paper on Policy options for implementing the Alternative Investment Fund Managers Directive

This response to the HM Treasury paper on the policy options for implementing the Alternative Investment Fund Manager's Directive (DP 12/1) is made by the British Private Equity and Venture Capital Association ("BVCA"). This paper is intended to supplement and provide further background to the arguments outlined in our initial response submitted on 4 May.

The BVCA is the industry body and public policy advocate for the private equity and venture capital industry in the UK. The BVCA Membership comprises over 250 private equity, midmarket and venture capital firms with an accumulated total of approximately £32 billion funds under management; as well as over 250 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include real estate funds, international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

In order to focus our response appropriately we have considered only those parts of the paper which we think raise issues relevant to private equity and venture capital firms.

Yours faithfully

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Margaret Chamberlain
Chair - BVCA Regulatory Committee

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HM TREASURY – OPTIONS FOR IMPLEMENTING THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

Q1. To what extent would a consistent approach of full application of Directive requirements across different types of AIFM benefit AIFMs, AIFs and investors in terms of investor understanding and reputation of the UK's financial services regulatory regime?

We do not support the full application of the AIFMD requirements to smaller AIFM. Such a step may prove harmful to the UK economy by depriving it of a vital source of liquidity without providing any real benefits by way of consumer protection or systemic stability.

The full application of the Directive requirements to all AIFM without regard to their size, investor type, preferred investment sector or any other criteria would not benefit investors and may cause them potential detriment. Investors in private equity and venture capital funds are typically large, sophisticated institutional investors who often have a good understanding of the complexities of the private equity and venture capital industries. Investors commonly spend a significant amount of time conducting due diligence on private equity and venture capital firms before making an investment and are therefore fully aware of the risks involved in investing with a particular firm. This is true irrespective of the size of the private equity or venture capital firm. Requiring smaller AIFM to comply with Directive requirements would not provide prospective investors with any additional security or information - instead it would increase the AIFM's costs and therefore reduce the investors' return.

The imposition of the full Directive requirements on smaller AIFM would impose barriers to entry that were unnecessary and not present in other European jurisdictions. This would, therefore, have a negative effect the reputation of the UK financial services regime. It may deter firms from establishing themselves in the UK for fear of burdensome regulation. This, in turn, would reduce competition within the market - having further detrimental impact on investor choice.

Q.2 What would the impact be on the different types of AIFMs, AIFs and investors – including those that would be subject to greater regulation than at present? What are the likely costs and benefits?

The AIFMD will introduce significant additional costs to all firms within scope. For firms which would be subject to additional regulation this effect will be further exacerbated by the additional costs of initial compliance. We enclose with this response three models illustrating the cost impact of the requirements on smaller firms. The first two models illustrate the effect on the profit of two small firms ("Start Up" and "Spin Out") of the regulatory capital and compliance costs of the Directive requirements. Although these models have been based on very conservative estimates of costs (the regulatory capital includes only the 25% costs requirement and the compliance costs are set at £70,000) the model shows that the firms would not begin to make a profit for its members for at least three years.

Many of the AIFM which fall below the size threshold are start-ups or spin-offs. The prospect of three years without making a profit will be a significant barrier for many individuals considering the option of establishing a fund and would discourage firms from establishing themselves in London.

The third model that we have included shows the difference in return to investors once costs to depositaries have been taken into account. We have assumed a depositary fee of 0.5% - 1% of commitments (which we consider a reasonable estimate based on the depositaries' potential liability). You will see from the model that the impact on return to investors is very significant. This will make the UK anti-competitive and may drive investors to alternative jurisdictions when considering investment options.

We have not identified any benefits of full application of the Directive requirements. We consider that it would be to the detriment of investors and would reduce competition and innovation in the financial services sector.

Q.3 What would be the likely impact on the AIF market of requiring full authorisation of all small AIFMs?

Please see our response at question 4 below.

Q.4 What other impact would this option have on different kinds of AIFs, AIFM, and on investors?

If small firms were subject to full regulation this would significantly reduce the number of funds establishing themselves in the UK. In turn, this may prove harmful to the UK economy by depriving it of a vital source of liquidity without providing any real benefits by way of consumer protection or systematic stability. Our general view is that as few as possible of the provisions of the Directive should apply to small UK AIFM which meet the threshold/size exemptions. The Directive does not mandate that any of its provisions automatically apply to small AIFM, unless they decide to "opt in" in order to use the passport. Small AIFM tend to manage venture and growth funds, making early stage investments, and it is critical that these AIFM are not discouraged from being based in the UK, and if the UK imposes additional rules on small AIFM which are not also imposed by other Member States, then the UK will not be seen as an attractive base for such firms.

The UK Government is currently seeking to increase the amount of investment into the UK economy in particular to stimulate the flow of funding to private companies of all sizes. Private equity and venture capital firms are an important source of such investment. The additional costs that AIFMD compliance will impose on these types of firms will reduce the amount of liquidity that they have available for investment. As we demonstrate in the enclosed financial models, smaller private equity and venture capital firms are significantly less well-placed to bear the costs associated with the Directive - in particular the costs associated with the regulatory capital and depositary requirements. Accordingly the amount of investment that smaller AIFM will be able to invest into UK businesses will be significantly reduced without any benefit. Similarly, the reduced return to investors will discourage investors from investing in UK based AIF. This is entirely counter to the Government's current initiatives.

The application of the AIFMD provisions to smaller AIFMD would not increase consumer protection. Collective investment schemes are already subject to strict regulation in the UK which already applies to many smaller AIFM. A preferred (although arguably unnecessary step) would be to extend the scope of collective investment scheme regulation to include different types of AIFM which are not already covered.

The AIFMD imposes operating conditions (at Article 31 et seq.) which place unrealistic expectations on private equity and venture capital firms and do not take account of the existing operational arrangements such firms have in place. Subject to the final drafting of the implementing Regulations, firms that are within the scope of the Directive will need to consider carefully what arrangements they need to make in order to comply. Were such conditions imposed on non-scope firms then this would be entirely disproportionate to their internal capacity and staffing capability and may prove unworkable.

The Directive allows for a registration regime and we believe that this is the option which should be explored. We note that those firms which would qualify as "small AIFMs" will potentially fall within the ambit of the proposed European Commission Directive on European Venture Capital Funds and there is nothing in the draft of that directive which requires full regulation (as opposed to registration). The UK should not impose a regime on small AIFM which is not required either under the AIFMD or under the proposed Venture Capital Regulation. In particular small firms (particularly those in the venture capital/private equity market) do not pose systemic risk issues and it is important that the UK approach is proportionate and not unduly burdensome on new entrants to the market.

Q.11 What are the costs and benefits of applying the approved persons regime to internally managed non-CIS companies? Do you consider the approved persons regime should be disapplied in the case of such companies?

The approved persons regime is currently a useful regulatory tool which enables the FSA to maintain regulatory oversight on a broad scope of firms. It is correct that it should be applied proportionally taking account of the approved person's responsibilities and the relevant regulated firm's size, activities and client base.

However, it is not clear that imposing the approved persons regime to internally managed non-CIS companies would be of any benefit in providing further oversight in addition to that provided by existing legislation. Directors at such entities are already subject to rules and requirements imposed through domestic legislation; additional legislative oversight will add further distraction to the directors' primary role, impose additional costs on the firm and create a further barrier to entry without providing any benefit.

The Paper correctly identifies at paragraph 2.25 that the imposition of the approved persons regime to such entities may present the UK as anti-competitive – not just within Europe (where such a regime would not be in place) but also globally.

Q.12 Non-CIS companies listed on the Official List are subject to the additional protection of Listing Rules. Do you believe they should be treated differently in terms of application of the approved persons regime to unlisted companies? What would be the costs and benefits of this?

As we have noted above, we do not consider that internally managed non-CIS companies should be subject to the approved persons regime. For the reasons we have outlined, we take this view in respect of Non-CIS companies which are listed on the Official List.

Furthermore, we consider it important to note that non-CIS companies should have the option to be internally or externally managed. If they choose not to be internally managed then they would not, in any event, be subject to the requirements of the approved persons regime.

Q.13 Do you agree that the UK should retain its current restrictions on the types of domestic fund that may be marketed to retail investors?

The private equity and venture capital industry do not commonly use fund types which are permitted to be marketed to retail investors in the UK. However we consider that when followed properly, the combination of the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (as changed) and the FSA Rules functions properly.

Accordingly we do not consider that further changes or additions are required.

Q.14 What additional restrictions should they be subject to?

We do not consider that any additional restrictions should be imposed.

Q.15 What would be the costs and benefits?

Additional restrictions on the way in which funds can be marketed is likely to reduce the number of potential investors, thus reducing the amount of investments made into UK AIF. This will, in turn, reduce the amount of liquidity available for investment in the U market. It would create additional costs for firms when becoming compliant with the new regimes and may cause difficulties for existing investors to whom firms may no longer be permitted to market new investments.

Q.16 Do you agree that the Government should not impose additional private placement requirements for third country managers of third country funds?

We agree that the Government should not impose additional private placement requirements for third country managers of third country funds as this would prove anti-competitive and the current private placement regime offers appropriate investor protection. Additional requirements may prevent third country fund managers from marketing in the UK, reducing the investment opportunities available for investors. If the UK is seen as imposing unnecessary regulations then this could, in turn, affect firms' decision to invest into the UK.

SPIN OUT (WITH AIFM REG CAP AND CAPITAL COSTS)			
LLP CASHFLOW			
	Year One	Year Two	Year Three
Old Fund	100,000,000	100,000,000	100,000,000
New Fund		100,000,000	100,000,000
Income	1,595,240	3,032,413	2,765,021
Expenses	1,531,306	2,108,553	2,233,758
	63,934	923,859	531,263
Capital Expenditure	0	0	0
Operating Cash flow	63,934	923,859	531,263
Opening Cash	0	382,826	387,555
Operating Surplus/(deficit)	63,934	923,859	531,263
Partners Capital requirement/(Drawings)	318,892	(919,131)	(499,962)
Closing Cash = EU AIFM Capital requirement	382,826	387,555	418,856

SPIN OUT (WITHOUT AIFMD REG CAP AND COSTS)			
LLP CASHFLOW			
	Year One (first closing)	Year Two (final closing)	Year Three
Old Fund	100,000,000	100,000,000	100,000,000
New Fund		100,000,000	100,000,000
Income	1,595,240	3,032,413	2,765,021
Expenses	1,531,306	2,108,553	2,233,758
	63,934	923,859	531,263
Capital Expenditure	0	0	0
Operating Cash flow	63,934	923,859	531,263
Opening Cash	0	5,000	5,000
Operating Surplus/(deficit)	63,934	923,859	531,263
			0
Partners Capital requirement/(Drawings)	(58,934)	(923,859)	(531,263)
Closing Cash = current capital requirement	5,000	5,000	5,000

PARTNERS PERSONAL CASH FLOW (WITH REG CAPITAL)			
Net capital (contribn)/drawings	(318,892)	919,131	499,962
Co investment requirement	0	(200,000)	(200,000)
Personal taxation	0	(69,574)	(518,280)
Payment for business	(11,000)	(149,537)	(136,168)
Cash flow for period	(329,892)	500,020	(354,485)
B/fwd	0	(329,892)	170,127
C/fwd	**(329,892)**	**170,127**	**(184,358)**

PARTNERS PERSONAL CASH FLOW (WITHOUT REG CAPITAL)			
Net capital (contribn)/drawings	58,934	923,859	531,263
Co investment requirement	0	(200,000)	(200,000)
Personal taxation	0	(69,574)	(518,280)
Payment for business	(11,000)	(149,537)	(136,168)
Cash flow for period	47,934	504,748	(323,184)
B/fwd	0	47,934	552,682
C/fwd	**47,934**	**552,682**	**229,498**

START UP (WITH REG CAPITAL and Compliance Costs)

LLP CASHFLOW

	Year One	Year Two	Year Three
Fund Size	39,000,000	100,000,000	100,000,000
Income	780,000	3,220,000	2,000,000
Expenses	1,231,850	2,009,300	1,303,370
	(451,850)	1,210,700	696,630
Capital Expenditure	100,000	0	0
Operating Cash flow	(551,850)	1,210,700	696,630
Opening Cash	0	290,763	315,735
Operating Surplus/(deficit)	(551,850)	1,210,700	696,630
Partners Capital requirement/(Drawings)	842,613	(1,185,728)	(697,941)
Closing Cash = Capital requirement	290,763	315,735	314,424

PARTNERS PERSONAL CASH FLOW (WITH REG CAPITAL)

Net capital (contribn)/drawings	(842,613)	1,185,728	697,941
Co investment requirement	(130,000)	(536,667)	(333,333)
Personal taxation	0	0	(844,855)
Cash flow for period	(972,613)	649,061	(480,247)
B/fwd	0	(972,613)	(323,552)
C/fwd	**(972,613)**	**(323,552)**	**(803,799)**

START UP (WITHOUT REG CAPITAL)

LLP CASHFLOW

	Year One	Year Two	Year Three
Fund Size	39,000,000	100,000,000	100,000,000
Income	780,000	3,220,000	2,000,000
Expenses	1,161,850	1,939,300	1,233,370
	(381,850)	1,280,700	766,630
Capital Expenditure	100,000	0	0
Operating Cash flow	(481,850)	1,280,700	766,630
Opening Cash	0	5,000	5,000
Operating Surplus/(deficit)	(481,850)	1,280,700	766,630
			0
Partners Capital requirement/(Drawings)	486,850	(1,275,700)	(761,630)
Closing Cash	5,000	5,000	5,000

PARTNERS PERSONAL CASH FLOW (WITHOUT REG CAPITAL)

Net capital (contribn)/drawings	(486,850)	1,275,700	761,630
Co investment requirement	(130,000)	(536,667)	(333,333)
Personal taxation	0	0	(844,855)
Cash flow for period	(616,850)	739,033	(416,558)
B/fwd	0	(616,850)	122,183
C/fwd	**(616,850)**	**122,183**	**(294,375)**

Fund Size £150.755 m	Actual	Incl. Fees of 0.5%	Incl. Fees of 1%
Quarterly Custodian Fee	-	188,444	376,888
Net IRR	24.1%	22.6%	21.2%