Report of the Alternative Investment Expert Group: Developing European Private Equity

Response from The Association of Investment Trust Companies

The Association of Investment Trust Companies (AITC) welcomes the Commission's decision to examine the European private equity market and to consider whether or not action is required at a European-wide level to develop a single market. The Report of the Alternative Investment Expert Group on Developing Private Equity is a useful contribution to this debate.

We are also keen to inform the Commission's thinking. One of our priorities is to highlight the role of listed private equity funds, which was not fully explored in the Expert Group's report, and to ensure they are properly taken into consideration as policies are developed.

UK listed private equity funds

Size of the UK investment company 'private equity' market: The AITC represents closed-ended investment companies listed in the UK, either on the main market of the London Stock Exchange or the Alternative Investment Market.

The investment company sector as a whole has some £76billion (€112billion) of assets under management. A significant proportion of this is invested in private equity. We estimate that around £10billion (€14billion) of the total is held in dedicated private equity funds. Other investment companies with more wide-ranging remits may also have private equity investments within their portfolios alongside other assets, such as listed equities.

Role of investment companies: The listed investment company structure is well suited to providing investors of moderate means with exposure to a diversified pool of assets. It allows them to spread their risk and gain the benefits of specialist fund managers in a cost-efficient manner. Investors are able to secure any capital gains they have made by selling their shares.

Investment companies can also provide income opportunities for shareholders by passing on dividends which accrue to the underlying portfolio.

Suitability of investment companies for private equity investment: Listed investment companies are particularly well suited to investing in illiquid asset classes (such as private equity) because their shares are traded on a stock market. The market matches investors who want to buy and sell their shares. This trading occurs without any direct influence on the composition of the underlying portfolio.

This contrasts with investment products such as authorised unit trusts. In these funds the manager is obliged to sell underlying assets to redeem a unit-holder with the cash value of their investment when the investor chooses to exit the fund. This is unproblematic where the unit trust is invested in listed assets, such as quoted equities. It would be impractical if the unit trust were to be substantially invested in private equity, where stakes in unquoted companies cannot be realised quickly for cash. The relationship between redemptions and the underlying portfolio means that unit trusts and other 'open-ended' investment products (where the portfolio expands or contracts according to whether investors are joining or leaving the fund) are less suitable for significant investment in private equity.

The fund manager of a listed 'closed-ended' investment company (where the underlying portfolio is not affected by shares in the investment company being traded) is not obliged to sell assets to meet redemptions. The market takes a view on the value of the investment company's assets, prices the shares, and matches buyers and sellers to enable them to trade.

Of course, unlisted closed-ended funds are also used to access private equity. They do not suffer from the same problems which affect open-ended funds. However, they involve significant barriers to entry for many investors.

Retail access to private equity: Investment companies provide an invaluable means for retail investors to gain access to an important asset class. Unlike many unlisted private equity funds, retail investors can obtain exposure to private equity assets without having to invest a lump sum, perhaps involving thousands of pounds/euros. The customary requirement to invest a substantial lump sum in unlisted private equity funds is a significant barrier to entry for the average retail investor. In contrast, access to private equity orientated investment companies creates no such hurdles.

Even with only a moderate sum to invest, a potential investor can either directly approach a stockbroker or dealing service to purchase shares on their behalf. This can be done either with or without advice. Alternatively, retail investors can purchase private equity based investment companies by using 'wrapper products'. These include the Individual Savings Account (a UK product which allows the shareholder to make capital gains and receive dividends without incurring a tax liability). Shares can also be purchased and held in 'self-select ' pension funds. Share purchases can be made even where investors have relatively small amounts to invest. Many investment company shares, including those offering exposure to private equity, can be purchased through savings schemes for as little as £50 (or €74) a month.

It is also worth noting that investment companies can provide exposure to a pool of private equity funds. This arises where they purchase a portfolio of private equity funds (listed or unlisted). Buying a range of funds provides a further level of diversification for retail investors. Investment company shares may also be purchased by other institutional investors, such as pension funds, which also indirectly give retail investors access to specialist management skills and private equity portfolios.

Easy exit: As well as having low barriers to entry, the ability to sell shares at any point is important for retail investors. Investors will normally be well served by holding investment company shares for a number of years (whatever asset class the portfolio is exposed to). Holding for longer time periods helps mitigate short term risks and volatility. However, it may be that, on occasion, circumstances dictate that shareholders may seek to redeem their investment before they had planned. As investment company shares are fully tradable they can be realised quickly with no penalties. This may not always be the case with unlisted private equity funds where there is often no secondary market.

Benefits of private equity exposure: The ability of investment companies to provide retail investors with access to private equity should be strongly welcomed by the Commission. It is increasingly recognised that individuals should devote resources to saving for their futures to secure their retirement and help them fulfil other lifestyle goals (perhaps buying a house, setting up a business, or supporting their children through university etc). Private equity is an important asset class which is becoming increasingly prominent on the investment landscape (alongside other alternative investment asset classes). Investors must be given the opportunity

to gain exposure to these assets if they choose. This both meets the Commission's goal of creating a single capital market and provides investors with new opportunities to secure their financial futures.

Private equity backed companies already make a significant contribution to the UK economy. Research published in 2005 by the British Venture Capital Association (BVCA) found that on average private equity backed companies increased:

- sales by 23% p.a., more than twice that achieved by FTSE 100 companies;
- exports by 20% p.a. compared with a national growth rate of just 3.3%;
- investment by 5% p.a. compared with a national increase of 1.9%.

These are significant achievements which we have no doubt have helped increase the overall economic growth of the UK. Certainly, according to the BVCA figures, 77% of companies which were themselves backed by private equity, reported that could not have existed or would have grown less rapidly without private equity involvement. Furthermore, private equity backed companies have been responsible for significant employment creation in the UK. Over the five years to 2003/04, private equity backed companies have increased their staff levels at a rate around five times that of FTSE 100 or FTSE Mid-250 companies. The number of people employed by private equity backed companies increased by 20% p.a., against a national private sector growth rate of just 0.6% p.a. Around 2.7 million people in the UK are estimated to be employed by companies backed by investment from British private equity, equivalent to 18% of the current private sector workforce.

This clearly indicates private equity's potential to support the Lisbon agenda. Just as critical is that the listed investment company structure allows a far broader range of retail investors access to the financial benefits that private equity can provide. This asset class should not be the sole preserve of either large institutions or very wealthy private individuals. The Commission should be supportive of the fact that listed investment companies offer the potential for people of moderate means to enjoy the benefits of investing in private equity should they choose to do so.

Regulatory position: Investors in listed private equity investment companies enjoy a robust regulatory regime to protect their interests. Investor protection arises from various sources. All listed investment companies will be governed by company law. They will have an independent board of directors with a duty to safeguard the interests of the shareholders (a structure unlikely to be paralleled in other structures). When they are domiciled within the European Union the requirements of their domestic law will also be informed by single market measures. Further company law rules are also being developed as the Company Law Action Plan is taken forward.

Where shares in an investment company are listed on a regulated stock exchange (such as the main market of the London Stock Exchange) they are fully transferable. This is required by both the UK listing rules and European directives. There are a range of European measures which inform the way in which listed investment company shares are traded, for example, by regulating stock exchanges and other intermediaries. Most recently the Transparency Directive has renewed the framework which requires ongoing disclosures from listed investment companies and the Prospectus Directive has created community wide requirements on disclosures when they make their initial public offering.

This paper does not go into detail on the regulatory arrangements governing listed investment companies but we are adamant that investors have sufficient protection. They are provided with high quality information which enables them to assess the risks involved in purchasing investment company shares and gives them an ongoing view of their investment. As shareholders they have important rights in relation to the governance of the company itself – including, for example, having a say in electing board members. Rules also ensure that the markets they rely on to trade their shares are orderly and transparent. The regime is comprehensive and robust.

The regulation of listed investment companies was recently examined in detail by the UK Government. This was an extensive public consultation that received over 120 responses. Its conclusion was that the current regime is robust and proportionate. It did not find that any significant changes were required to alter the structure of investment company regulation. Instead it wanted to maintain the overall approach and for the rules to be adjusted incrementally as required. (A process which will be informed, for example, by the implementation in the UK of the Transparency Directive and the proposed directive on shareholders' rights etc.)

Developing the role of listed private equity investment companies: The AITC strongly recommends that, in considering how the European framework for investment funds is developed, the Commission should take full account of the possible implications of its policies for listed funds. Listed private equity investment companies are a significant, albeit minority, proportion of the market. They provide access for retail investors as well as capital to support the Lisbon agenda.

Developing the European single market for private equity funds

The UK provides a benign environment for private equity and the market is well established. It enables the creation of private equity funds (both listed and unlisted). It also has few barriers to funds taking up UK-based private equity opportunities.

The AITC recommends that the Commission's primary focus should be on identifying and addressing barriers to private equity funds making deals in individual Member States (rather than dealing with fund formation). This will offer the fastest way of deepening the market for private equity. In turn this will generate economic growth and employment across the Union – which should be the primary objective of any action in this area).

Removing barriers to cross-border investment by private equity funds will increase the amount of capital available to companies in each Member State, who will no longer be restricted to domestic sources. It will increase the quality of private equity interventions which also incorporates the provision of expertise to assist the company's management. This maximises the company's commercial potential. Greater competition between private equity providers should therefore make it easier for investee companies to identify backers who offer inputs which match their commercial requirements. Notwithstanding this, we do have some reflections on other issues, including the policy issues raised by the Expert Group.

Tax on capital gains within the fund: The AITC strongly supports the proposition that private equity funds should only be taxed in their home country on capital gains. We recommend that the Commission should take any steps it can to encourage mutual recognition arrangements which ensure this. All arrangements of this type should recognise both listed and unlisted

funds as necessary – even if one Member State involved does not currently have any listed funds. We envisage that most listed private equity funds will not have their capital gains taxed in other Member States, but we are keen that the Commission should be prepared to support the industry where problems in this area emerge.

We also support the expert group's recommendation that Member States should not be allowed to identify the use of local advisors as grounds to find that a private equity fund is 'permanently established' in that country for tax purposes.

Qualified investors: The AITC recognises the Expert Group's call to facilitate cross-boarder purchases of private equity funds, perhaps through action on defining qualified investors. We agree that investors should be able to purchase funds not domiciled in their home state. As listed private equity vehicles are traded on a public market we do not envisage that this is a significant problem for this sector. However, in the event that there are barriers identified, the AITC recommends that the Commission should act to tackle impediments to cross-border investment. We note, for example, the work currently being done by the Commission to develop a directive on cross-border shareholder rights, which the AITC has been contributing to. This should help make cross-border investments in listed private equity investment funds more attractive and ensure shareholders are fully able to exercise their rights. However, if there are other more direct barriers to purchasing investment company shares these should be resolved.

Legislative review: The AITC endorses the Expert Group's recommendation that policymakers in Member States and the Commission should recognise the potential impact their actions would have on private equity interests. The AITC would also reiterate its general recommendation that policymakers should be obliged to conduct a full regulatory impact assessment, including a cost benefit analysis, as part of the policymaking process. This will ensure that unnecessary legislation can be avoided and that any that is introduced is proportionate. This process should provide the opportunity for private equity interests to ensure their views are properly considered.

State aid: The AITC notes the Expert Group's comments on State aid. We recommend that, within the boundaries established by the European Union, Member States should be able to use state aid to enhance the environment within which small and medium sized entities are seeking to operate. This might include developing infrastructure or workforce skills. We recognise the Expert Group's concern that the definition of an SME needs to be made consistent across the Union and refined so that private equity companies are not disadvantaged in their access to SME support schemes. This will ensure that similar companies are given access to any assistance which may be on offer. We recommend that the Commission considers these issues as it develops its action plan on private equity.

However, we would also sound a note of caution. State aid can be problematic where it intervenes inappropriately in individual companies. This assistance can cause problems in a number of ways. It might limit opportunities for private equity funds to support companies affected. This would be undesirable because it would prevent their expertise (as well as funding) being deployed on behalf of the company. It may also prevent the full rigour of market discipline being imposed on the company, which will compromise its ability to become a strong competitor with long-term prospects.

Perhaps even more importantly, inappropriate state aid might damage the prospects of other businesses whose efforts to compete are undermined. It is of course important that Member States support their fledgling companies but this should be done in the proper way. The AITC recommends that the Commission should continue to be alert to the potential for state aid to distort and damage the commercial private equity market. It should continue to enforce proper discipline on the provision of state aid by Member States as required. It should ensure that state aid should not be used to capture investment opportunities and deny cross-border investment.

Accounting standards: The AITC shares the Expert Group's concern about IFRS and the limitations of a 'one-size-fits' all approach. We share concerns that requiring private equity companies to consolidate the profits and losses of all investees may reduce the level of meaningful information included in their accounts. This issue is already relevant to the listed private equity investment companies we represent. We agree with the Expert Group that it is likely to be relevant across the board if, as anticipated, IFRS becomes further embedded.

We recommend that the Commission should give serious consideration to the potential there may be for securing a greater degree of flexibility within the accounting standards regime for private equity funds (and other unusual cases, such as financial instruments) where a standard approach may be less than helpful for those relying on accounts to make investment decisions. The AITC also recommends that the Commission consider pressing standards setting bodies to use regulatory impact assessments/cost benefit analysis in the development of standards to determine if they are appropriate.

Conclusion

Listed investment companies with private equity portfolios make up a significant part of the European private equity market and offer unique benefits – for example in opening up this asset class to retail investors and in offering a robust method of mobilising capital for the sector. The AITC is adamant that the needs of this sector should be taken fully into account in any activity the Commission takes forward in this area. We would welcome the opportunity to participate directly in discussions in this area if possible.

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