

## AFIC'S RESPONSE TO THE REPORT OF THE ALTERNATIVE INVESTMENT EXPERT GROUP RELATING TO EUROPEAN PRIVATE EQUITY

The French Private Equity Association, the Association Française des Investisseurs en Capital (AFIC), welcomes the Commission's initiative to broach discussion on the regulation of investment funds and Private Equity funds in particular in Europe.

### **INTRODUCTION**

#### **The Association Française des Investisseurs en Capital (AFIC)**

As a wholly independent association, AFIC federates and represents all the companies engaged in French Private Equity business, which provide it with substantial credibility as the spokesman for the Private Equity business in its dealings with entrepreneurs, institutional investors, government authorities and opinion-makers. As of September 2006, AFIC counts :

- 229 active and professional members, representing almost the totality of Private Equity firms based in France: Venture Capital Funds (FCPR), Innovation Funds (FCPI), Local Investment Funds (FIP), Venture Capital Companies (SCR), investment firms, consulting firms, funds of funds...and,
- 150 associate members, whose professions are ancillary to Private Equity: attorneys, accountants, auditors and bankers...

#### **The French Market**

- The French market in terms of activity, contribution to growth and employment France is the second European country in terms of activity, and first on continental Europe.

Since 1995, the French private Equity market has grown quickly, with an average annual growth of 27% over the past ten years. In 2005, the activity of French private equity investors recorded a growth of 56% compared to 2004. 8.1 billion euros were invested in 2005 against 5.2 billion euros in 2004. Disinvestments made in 2005 amounted to 4,3 billion euros. This represents a growth of 35 % compared to 2004. 2005 was a record year with a total amount of 12 billion euros raised by private equity actors against 2.2 billion in 2004. In 2004, more than 3.700 French SMEs were financed thanks to Private Equity operations. Those companies have known an average turn-over growth of 5%, totalling 133 billion euros realised in France in 2004. This represents 8.6% of the gross domestic product (GDP)

Over and above Private Equity's economic contribution, its contribution to employment has continued to grow. In 2004, companies financed by Private Equity created 39.000 new jobs in France. Furthermore, Private Equity companies employed more than 1 million people in France and close to 6 million people in Europe in 2004.

## - The French vehicles

The investment vehicle that is most often proposed to institutional investors in France is the Private Equity Investment Fund (FCPR). This vehicle has also been adapted so that it can be used in the form of a Fund of Funds. There is also the Private Equity Investment Company (SCR) or the Local Investment Fund (FIP) introduced in 2004. The purpose of these investment structures is to foster investment in unlisted companies. They have different legal and regulatory operating procedures but comparable taxation systems for the institutional investor.

The **Private Equity Investment Fund** is part of the wider mutual fund (UCITS) family. It is differentiated by regulatory specificities that take into account aspects related to the frequency, nature and risks of investments in unlisted companies. The FCPR is a co-ownership of securities with a limited life. It is owned by the investors or subscribers and is managed by a management company according to rules set out in the fund's by-laws. The by-laws are a veritable contract between the investors and the management company. They set out the investment policy and the portfolio management rules and specify the commitments, rights and obligations between the parties. Their purpose is to provide investors in a long-term partnership with a guarantee that their interests will be protected and that the results and risks will be fairly shared.

There are two types of Private Equity Investment Fund: FCPR "agrees", those authorized by the French Financial Markets Authority (Autorité des Marchés Financiers) and, abridged procedure funds, FCPR "allegés". The former can raise capital on the capital markets the latter can only raise capital from "qualified" investors. Abridged procedure funds are not exempt from AMF control but have more freedom to set the special terms and conditions for the fund's management.

There are two successive periods during the life of a Private Equity Investment Fund (ten to twelve years on average):

- during the three to five year investment period, the management company gradually calls on investors to provide the funds they have subscribed to. These calls are usually in tranches of 5% to 10% based on the needs of the management teams to carry out investments in the chosen companies;
- during the second period, managers concentrate on raising the value of portfolio investments by actively monitoring them prior to preparing their sale. Investments are sold off to other companies or are floated or sold off to other investment funds. The proceeds from the sales are distributed to the subscribers as they are received. Such distributions are made primarily in cash or exceptionally, by allotting company shares after the IPO. Depending on the pace of investment acquisitions during the investment stage and the management teams' ability to sell them off during the realization stage, the profile of the financial flows – frequency of calls for funds and distributions – and the complete life of a fund may vary widely.

Benefiting from a specific tax regime, the **Private Equity Investment Company** is established as a joint-stock company in which the shareholders are the investors. The company's sole mission is to manage a portfolio of unquoted transferable securities of at least 50% of its net asset value. Operating under similar management and control regulations to those of a Private Equity Investment Fund (FCPR), these vehicles have, however, a much longer life-span. This vehicle category can be favoured over an FCPR when the shareholders' strategic objective is the reinvestment of gains over a undetermined period of time. The managers are usually employees of the Private Equity Investment Company.

The fund of funds is a structure for sharing investments in several private equity funds. The fund of funds is managed by a team of professionals offering investors the services for the strategic construction of a diversified portfolio and the selection of management companies. These professionals manage the relationships with the various underlying funds, organize the review of valuations, transfer information and provide back office services for the funds. In 2003, there were around 120 fund of funds management teams worldwide including 50 based in Europe and 10 in France.

## **AFIC'S RESPONSE TO THE REPORT**

First of all, AFIC would like to acknowledge the excellent quality of the Expert Group's work. AFIC has the following comments to make on the main recommendations made by the expert group.

### **AFIC's observations on the recommendation relative to common approaches to issues.**

As the representative of the Private Equity industry, AFIC has followed with great interest the commission's work on investment funds and private equity funds.

However, AFIC must follow with great attention any (attention)?! applicable to Private Equity clients that may interfere with its members' activity. AFIC wishes to take the opportunity of this response to stress that EU legislation or, for that matter, any such international regulation, can have major repercussions on the activity of national Private Equity firms. This was the case of Bale II and IFRS. This is the case of the MIFID Directive. This may be the case of the Solvency II Directive.

This is why it is necessary that, when drafting regulation, the EU regulator should pay great attention to the impact that this regulation may have on Private Equity industry, especially when this regulation concerns the clients of Private Equity structures: pension funds, banks, insurance companies...

Thus, AFIC can only approve of the group's recommendation relative to the necessity for policymakers to "consider the characteristics of the private equity industry when reviewing existing or drafting new legislation".

As pointed out by the experts, in order to foresee the impact of its regulation on the European private equity market, the European regulator must have a better understanding of the said market. AFIC recommends that national venture capital associations in general, and AFIC itself in particular, must go to further lengths to explain the specificities of the private equity industry to the EU legislator.

Furthermore, the Group recommends that "Member States should take a consistent approach to issues that affect the private equity industry, and when implementing national and EU laws, not introduce obstacles to the development of a single market for private equity funds."

AFIC agrees with this recommendation. However, AFIC considers that, beyond not introducing obstacles, Member States should create conditions for the development of a single market. In particular, European domestic vehicles should be recognised by each Member State at both legal and fiscal levels.

Moreover, portfolio management companies that are accredited in one country, should benefit from a passport: i.e., should be able to set up any vehicle in a foreign country without requiring accreditation and with no further cost to the company.

### **AFIC's observations on the recommendation relative to using levers at national level to promote private equity investing**

AFIC supports the recommendation concerning the need for a "prudent person" concept to be applied to institutional investors across the EU.

### **AFIC's observations to the recommendation relative to funds**

AFIC strongly supports the recommendation relative to fund structuring. It is obvious that the issue of the taxation applicable to the final investor is of great importance. The transparency regime which means that the investor is taxed as if he had invested directly ensures that there will be no discrimination between direct and indirect investment and/or between domestic and cross-border investment.

At a European level, the transparency regime implies that the investor must only be taxed on capital gains in his home country. Therefore, Member States must look through the private equity vehicle to the end investor to ensure that tax is applied only in the home state of the investor – in respect of private equity funds that are deemed to be fiscally transparent in the private equity fund's home state and Member States in which private equity funds employ managers to manage local investments must not use local presence to claim jurisdiction over capital gains accruing to the fund.

However, there are others fiscal issues. It would be particularly appropriate to clarify the following issues indeed:

- management has been situated in the UK, until now, essentially because of the fiscal and social rules regarding natural persons serving as managers. In this way the graph found on page 18 is very instructive,
- some structures in certain Member States go well beyond simple fiscal transparency, since they are intended for, or in any case have the effect of, transforming, depending on the case, yields into capital gains, or capital gains into yields, according to the fiscal needs of the investors.

In both cases, the dumping which can occur in one country can result in upsetting the normal course of its free market competition, and thereby render the European Private Equity market more opaque.

