



20 September 2006

**European Commission**  
Internal Market and Services DG

**Report of the Alternative Investment Expert Group (Developing European Private Equity)**

**COMMENTS BY THE FINNISH MINISTRY OF FINANCE**

The Finnish Ministry of Finance limits its comments to the Report of the Alternative Investment Expert Group (Developing European Private Equity, below referred to as "the Report"). On issues related to the Report of the Expert Group on Investment Fund Market Efficiency and the Report of the Alternative Investment Expert Group (Managing, Servicing and Marketing Hedge Funds in Europe), we refer to the reply we gave on 15 November 2005 on the Commission Green Paper. We appreciate the possibility to present our views in this matter.

**Firstly**, we find the work well done. The analysis has been carried out thoroughly. The Report gives a good idea of the state of play, both with regard to the challenges facing the industry and the regulatory obstacles market participants see as holding back business development. The barriers appear to be correctly identified and many interesting points are raised. We look forward to receiving the Commission White Paper, due next November.

**Secondly**, we find it challenging and important that the issues raised in the Report interact with the priorities of Finnish EU Presidency on "Innovation". Even if private equity gives only one perspective on promoting innovation, it appears to be an area where progress is urgently needed. We, therefore, encourage DG Internal Market and Services to maximize detailed analysis of concrete elements from the ongoing consultation. Ideally, such an analysis could contribute to the measures foreseen in the Commission Communication on Implementing the Community Lisbon Programme, published on 29 June 2006. Additionally, it would be of added value to identify how the forthcoming White Paper would best serve the goals set in that Communication, in particular with regard to removing obstacles to the efficient and competitive development of the EU private equity industry. Therefore, we would prefer not to limit the scope of the White Paper to focusing on necessary regulatory measures only, since all obstacles are not related to regulation.

**Thirdly**, we find it necessary to raise doubts with regard to some of the conclusions of the Report. We believe it does not necessarily send the right message on mutual recognition. We find it difficult to foresee that the principles of home country control and mutual recognition could be homogeneously applied without harmonizing, at EU level, the essential regulatory criteria of private equity funds and/or management companies managing such funds. For example, it appears for the time being unclear whether in all EU Member States it is in the competence of the supervisory authorities to recognize non-harmonized funds operating cross-border. If such a competence is granted to the supervisory authority, often a number specific criteria are set. This is the case for instance in Finland.

Therefore, encouraging bilateral arrangements between supervisory authorities instead of striving for multilateral arrangements might contribute to the further fragmentation of regulatory practices. Further, this approach is linked to the heavily debated issue of whether cross-border distribution of non-harmonized funds is considered legitimate according to MiFID (2004/39/EC). If private equity funds were structured as collective investment undertakings, as in some EU Member States, they would be regarded as non-harmonized funds. It is somewhat unclear whether they in that case would fall under the scope of MiFID. Collective investment undertakings, whether coordinated at Community level or not, are excluded from the scope of MiFID according to Article 2(1)(h). However, collective investment undertakings are defined as financial instruments in Article 4(1)(17) and in Annex C of MiFID.

The ambiguity between the scope of MiFID and the UCITS Directive (85/611/EEC) and the challenges this sets to achieving a level playing field are well known. We understand that there are views demanding a national authorization to a non-harmonized fund as a condition for the funds to be regarded as collective investment undertakings in the meaning of Annex C of MiFID. However, such a requirement would lead to fragmentation, since no criteria of authorizing non-harmonized funds are set in MiFID. In our view this requirement would mean that management companies and investment firms were put to different positions, if authorized non-harmonized funds could be distributed cross-border on the basis of MiFID, while management companies would be excluded from the scope of MiFID. We find it difficult to grasp how this requirement would serve to achieve a management company passport, a goal that the Commission has had for a long time. We would be delighted if this ambiguity is solved in the forthcoming White Paper.

In our view it is, therefore, not coherent to seek the removal of unintended consequences of legislation and simultaneously demand bilateral arrangements, which would take advantage of conflicting interpretations of EU legislation. We consider that the position presented in the Report is therefore close to cherry picking, where the advantages offered by EU law are sought without taking account of the corresponding obligations. Instead, we would encourage the Commission to explore the opportunities of existing EU law.

Additionally, we would prefer, in the long-term, a framework directive on cross-border distribution of funds, whether these are harmonized at EU level or not. As also mentioned in our abovementioned reply of 15 November 2005 to the Commission Green Paper, we would find it useful to study the material coherence in EU company law, in EU financial services law and between those two areas of legislation. We notice that coherence within company law was also raised in the Commission open hearing on 3 May 2006 on the Company Law Action Plan (see Summary Report, page 31). Adding further coherence might also serve the long-lasting demand for a European fund structure regarding private equity funds. One possibility would be to analyze the claimed unintended consequences of legislation in a structured manner within the ESC and CESR.

However, if the approach based on bilateral arrangements between supervisory authorities were considered preferable, we would encourage the Commission to take an explicit stand on the issue. Till now, we have understood that the Commission would prefer multilateral arrangements, as in the so-called Level 3 measures in the Lamfalussy structure. However, the bilateral Memoranda of Understanding have become increasingly popular among supervisory authorities. Since MoU:s are in essence a soft law instrument, a multilateral arrangement would create peer pressure, which would more effectively safeguard predictable application of such soft law instruments. A prime example of a multilateral

MoU is the agreement on co-operation in financial crisis situations, which has been endorsed by more than 70 banking supervisory authorities, central banks and finance ministries of the EU. According to a press release of 14 May 2005 by the Luxembourg Presidency of the Council, this non-public document entered into effect on 1 July 2005.

One possible avenue to clarify the state of play might be to explore co-regulatory measures together with the industry. Since private equity funds are not explicitly regulated at EU level, the so-called Level 3 measures used in the Lamfalussy structure might be an option, even if they have been used only scarcely so far. In any case, we think it is extremely important that the Commission is both sufficiently even-handed and ambitious in its future plans, so that a balanced approach can be ensured.

**Fourthly**, in our opinion the lack of tax harmonisation referred to in the Report should not be seen purely from a negative standpoint. It has to be borne in mind that regulatory arbitrage is not necessarily harmful in itself. In many areas of financial services law, in particular in the areas linked to taxation, it might also have a positive effect on European regulatory environment. Taking into account the difficulties in harmonizing tax regimes within the EU, it might be worth exploring other measures than binding European law. The Report raises useful perspectives and encourages exploring alternatives to binding tax law. One way to make progress would be to gauge best practices, as recently agreed within the Ecofin Council. Since product development in financial services essentially interacts with tax incentives, it is crucial to seek sound interplay between financial services and taxation.

With regard to taxation, it is evident that it is a true challenge to European harmonisation. Benchmarking and guidelines have proven to be an efficient approach in comparing EU Member States' activities. Additionally, the regulatory arbitrage forces the EU Member States to be vigilant in their tax policies. It would be useful if the cases of double taxation encountered by cross-border venture capital investments were identified, perhaps by the expert group to be set up next March by DG Taxation and Customs Union mentioned in the Annex of the abovementioned Communication of 29 June 2006. In addition, it could be analyzed whether bilateral tax treaties between EU Member States could be modified to encourage in particular cross-border venture capital activity. Contrary to our view on the usefulness of bilateral arrangements in financial services issues, in the area of taxation they can be used as an established tool to arrange cross-border co-operation.

One particular issue, which should be examined more closely, is the taxation of partnerships. This work could gain from the surveys already done within the OECD. With regard to partnerships, it appears that there seldom is written law on the issue. Instead, there are sporadic case law and interpretations, which together have created administrative practices. In particular the classic regime of the passive role of the silent partners has proven to be problematic in cross-border venture capital activity. According to the classic regime, the silent partner is expected to be only a passive investor in a partnership. If the silent partner is active in a partnership domiciled in an EU Member State other than the silent partner, tax transparency is often violated. This activity can also be constructed indirectly when the silent partner is deemed to gain from the activity of the general partner or of the partnership itself. Thus, many national tax regimes within the EU construct a permanent establishment to the silent partner in the EU Member State where the partnership is located. Therefore, tax transparency is not guaranteed and the silent partner becomes subject to taxation also in the EU Member State where the partnership is located. Even if this problem has been identified in the Report, no concrete measures to resolve it are proposed.

It might be useful if the Commission should combine its efforts to the work done at the OECD. The basis of many tax treaties is the OECD model tax convention on income and capital. The ongoing work within the OECD on the taxation of investment funds and trusts might also be of benefit to the efforts of the Expert Group on Investment Fund Market Efficiency.

**Finally**, we find it crucial to emphasize the policy particularly designed to support early stage investments. The importance of venture capital has also been frequently underlined by the Commissioner of Internal Market and Services. However, it is not only a European issue, but also in the US several institutional investors have withdrawn from venture capital financing. It is necessary to make a distinction between private equity and venture capital. We do not see any specific need to support buy-out activity with e.g. tax incentives. We believe that to venture capital should be given more attention than to private equity, if measures need to be prioritized in the Commission. Since private equity tends to grow rapidly e.g. due to low interest rates, the small funds investing in venture capital would need a boost. This problem is linked to innovation, growth and competitiveness, which have recently been highlighted also within the Ecofin Council.

Best regards,

Peter Nyberg  
Director General