

Report of the Alternative Investment Expert Group

Developing European Private Equity



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European Commission
Internal Market and Services DG



Preface

In July 2005 the European Commission launched a public debate on possible ways to enhance the European framework for investment funds. While the debate focuses primarily on retail investment funds that fall within the existing legislative framework (UCITS¹), the Commission also observes the strong growth of the alternative investment market, which includes private equity funds.

The report's analysis and recommendations, as well as other stakeholders' reactions to those, will be taken into account by the Commission when assessing the options to improve the working of the framework for investment funds. The Commission plans to publish the results of this assessment in November 2006. At the same time, a White Paper will define the concrete actions needed to drive forward improvements in the investment fund area.

The present report represents one of the first opportunities for a group of private equity fund practitioners to contribute to the policy debate on the development of this fast-moving business. This Group report is an opportunity for the industry to explain how it sees the challenges and identify areas for possible improvement. It gives the Commission a chance to address preconceived notions about the private equity industry.

The Commission invited this Group to report on how the industry operates, what are its defining characteristics in the European context, and whether there are any European-level regulatory or other obstacles which hold back the efficient development of the business in Europe. It also hopes that this analysis and associated recommendations serve to fuel a wider debate on the successful development of this industry in the European context.

This report reflects the outcome of discussions within the Expert Group on private equity over the period February – June 2006. During this period, the group met four times on the basis of an evolving draft of the report.

The role of Commission staff in the groups was to facilitate discussions – by providing secretarial support in organising and hosting the meetings, and contributing to put together the report. Consequently, the Expert Group's report should not be construed as reflecting the position of the Commission or of its services.

The Commission services now wish to submit the assessment and views of the Expert Groups to wider scrutiny and open debate before developing a basis for a formal position. To this end, Commission services have organised an Open Hearing in Brussels on 19th July. Stakeholders are also welcome to send written comments to the below address. Reactions will be published on our website unless a confidential treatment is explicitly requested.

These can be e-mailed to markt-consult-july-2006expertgroups@ec.europa.eu until 20th September 2006.

¹ Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

- Executive Summary -

The European **private equity industry** is maturing and growing in stature. This will strengthen the financing chain for European enterprises. The industry plays an essential role in mobilising private investment capital with a view to investing, mainly in private enterprises, thereby helping those companies to grow and develop. The European private equity industry can provide attractive investment returns to institutional investors some of whom are engaged in the provision of investment services for life time savings and old age provision. A successful private equity industry is not a panacea for macro-economic underperformance and poor competitiveness. But it can make an important contribution to the re-generation of the economy by nurturing new enterprises and re-energising existing companies. In so doing, it can lay the seeds for sustained growth and job-creation and assist in the drive to be increasingly globally competitive. If the EU is to harness this potential, there will be a need for a greater understanding in many Member States and at the EU level of the way in which the private equity industry is organised and carries out its business. The industry could make a greater contribution if the regulatory and tax environment across Europe took better account of the specificities of this business.

This report describes the private equity industry. It explains why private equity is important and how it is different from other types of investing. It highlights its particular contribution to increasing European competitiveness and commercialising innovation; to strengthening company governance and management; and to preparing companies for further growth and public offer. It has a proven track record in increasing productivity and profitability and at the same time creating jobs. Private equity plays an important role in bringing private companies onto the public markets and facilitating the adoption of advanced and transparent governance rules.

A private-equity friendly policy framework should recognise important differences and challenges facing different segments of the business. Buy-out and venture capital markets make different contributions to the economy.

Buy-out financing has considerable potential for growth in supporting profitable change in segments which might otherwise underperform or even fail. It can also make an important contribution to facilitating "generational change" in family owned businesses. This report presents a realistic understanding of the challenges facing the **venture capital industry** in Europe, how it operates and its particularly important contribution as part of a policy to stimulate entrepreneurship and new employment. Venture capital investment activity in growth businesses, new technologies and sectors thrives in "clusters". The Group recommends that the EU framework should remove impediments to the emergence of these clusters in Europe. Although the challenges for developing these two market segments differ in some important respects, both venture capital and buy-out markets face the same problems when seeking to develop cross border activities in the EU.

The private equity industry has developed successfully on the basis of relationships between sophisticated actors which have been constructed in accordance with privately negotiated agreements undertaken between fund managers and their "professional" investors. The industry adheres to self imposed industry standards which have been created in conjunction with investors/clients. The current mix of self-regulation and light-touch supervisory oversight remains a viable basis for the continued development of the industry and its business model. The institutional nature of the investor base is an important reason. This explains why this asset class does not need intrusive regulatory involvement in the conduct of business and management of assets.

² e.g. Silicon Valley, Boston, Cambridge, Grenoble, Øresund

Nevertheless, there are areas for improvement in the environment for private equity. This report recalls some of the most important improvements that are urgently needed to provide practitioners with a suitable onshore tax and regulatory environment. This is essential if Europe is to compete with other private equity markets such as the US, and to be attractive to investment.

As the legal, tax and operating environment in which private equity develops is determined largely at **national or local level** this must be the first focus for attention. Most Member States regulate part or all of the private equity value chain (fund manager, fund registration). The more developed and successful EU markets have a more private equity-friendly environment. This usually reflects a deliberate policy towards stimulating private equity, in recognition of its role and benefits to the wider/whole economy. However, Member States do not necessarily provide solutions for transnational recognition of fund structures from other EU Member States.

Therefore the Group encourages national policymakers to use the levers available to them to develop this important source of finance. It encourages Member States to learn from each other's experiences and to put in place the optimal conditions at local or national level to facilitate the development of this form of financing. Specifically, there is widespread recognition of the market failures that weigh on the venture capital business. Member States now have the leeway to implement effective programmes to support this important structurally-challenged activity, particularly through State Aid policies.

There are also **challenges and issues at European level**: The Group stresses that EU policymakers must consider the specific characteristics of the private equity industry when reviewing or drafting legislation. The adoption of cross-cutting company law, accounting or financial services initiatives have generated unfortunate unintended consequences for the private equity industry. This may result in legal uncertainty or reporting and compliance requirements and different national interpretations which are unsuitable for private equity business models. Significant examples arise in relation to the definition of "Small to Medium size Enterprises", International Financial Reporting Standards and provisions in the Markets in Financial Instruments Directive. The Group asks that the provisions in question be reviewed and applied in a way which takes better account of the reality of private equity. It pleads for systematic account to be taken of the potential impacts of company law and financial services legislation on the private equity business.

However, the greatest challenge for/within the EU is to ensure a pragmatic and sensible approach to the taxation and oversight of private equity business originating from other Member States. Europe's national regimes do not interlink and are heavily fragmented. They make little concession to the growing cross-border or international dimension of the private equity industry.

There is a broad understanding that cross border investments could be far more significant if funds did not encounter substantial administrative burdens and restrictions to cross border deals or capital raising.

Actors are more inward-looking than would be expected in a true single market. Fundraising and investments are not evenly spread throughout the EU. Member States have been able to adapt their tax and supervisory approach for other financial sectors. We need to find ways to build on these precedents – to find sensible and pragmatic approaches for facilitating the cross border private equity industry.

This report explores the principal barriers to the development of the industry on a European wide basis. It argues that further integration of the EU market would allow the private equity business to play its full role in supporting entrepreneurship and corporate regeneration. It builds a case for proportionate change based on the concepts of mutual recognition of existing national laws and a consistent approach to European issues. The paper does not aim to be a comprehensive report on all

aspects of private equity markets; however, it looks in particular at the two most urgent areas where steps should be taken to facilitate market development and integration: i) fund vehicles; and ii) fund marketing. Progress on these fronts would increase the efficiency of the EU market to the benefit of investors and facilitate the smooth flow of resources towards investee companies in all Member States.

Fund structuring:

The efficiency of the EU private equity industry suffers from an overly complex and ill suited fund structuring environment which does not support cross border investing. The additional costs and the additional risks for investors and funds associated with this serve to make the European industry less effective than it could be, particularly in comparison with the US. This is particularly problematic for smaller venture capital and buy-out funds, especially those players operating in smaller and less developed markets. The industry wants to be able to invest in EU projects on a cross border basis in the same way as other financial transactions (public equity investments).

- The guiding principle for enlightened and single-market-compatible taxation of private equity funds is that the investor only be taxed in its home country on capital gains.
- For capital gains tax purposes Member States should look through the private equity vehicle to the end investor. In so doing, they should ensure that tax is applied only in the home state of the investor in respect of funds that are deemed to be fiscally transparent in their own state. The EU institutions and Member States are urged to take appropriate steps to codify the mutual recognition of each other's fiscally transparent private equity fund structures for capital gains [similar to public equity investments].
- The Group recommends that for tax purposes Member States treat investments in vehicles that are used to pool assets invested in private equity investment programmes in the same way as they treat public equity investments. In particular, Member States in which multi country funds employ dependent advisors to manage local investments, should not use this local presence to claim jurisdiction over capital gains accruing to the fund. Specifically, this implies not regarding the local advisors as a **permanent establishment** for tax purposes.

Cross-border placement of private equity funds:

The Group calls on EU institutions and Member States to facilitate the cross-border marketing and placement of private equity investments with eligible professional investors in other EU Member States. Member States should take a consistent and light touch approach to implementation of EU laws that affect the private equity industry and not introduce obstacles to professional investors accessing private equity funds.

The Expert Group recommends that EU institutions and Member States consider establishing a common understanding of the parameters of "private placement". This could involve building on, with adaptation in relation to experience/dealing frequency, useful provisions of existing Community law as regards the notion of "qualified investors" who can be approached without triggering mandatory disclosure or conduct of business rules.

Recommendations

The environment for private equity

- ❖ The Group strongly encourages national policymakers to use the levers available to them to develop private equity finance. We would urge Member States to learn from each other and to create the optimal conditions at local/national level to facilitate the development of this important form of financing. The Group believes that institutional investors should not be faced with arbitrary or outdated quantitative restrictions. The Group considers that there is a growing need for a "prudent person" concept to be applied to institutional investors across the EU. This could start with investor groupings for which such a concept already exists but which is still inconsistently implemented through national implementation of the IORP Directive³.
- ❖ The Group recommends that policymakers consider the characteristics of the private equity industry when reviewing existing or drafting new legislation. Where it can reasonably be foreseen, impact assessments should take the characteristics which define the private equity industry into account to avoid the unintended impacts of EU initiatives on the private equity industry. Where the impact is intended, the policy objectives should be developed with an understanding of the key drivers of the private equity industry so that any measures will have the intended outcomes. In making this recommendation the Group acknowledges that the industry itself must do more to explain the specificities of the business clearly to a wider audience in terms that accurately capture the business objectives, structure and characteristics of the private equity industry. The Group argues 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. The Group recalls that funds managing smaller pools of capital are particularly affected by inappropriately drafted or targeted legislation

Fund structuring

- ❖ The guiding principle for enlightened and single-market-compatible taxation of private equity funds is that the investor only be taxed in its home country on capital gains. For capital gains tax purposes Member States should 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. The EU institutions and Member States are urged to take appropriate steps to codify the mutual recognition of each other's fiscally transparent private equity fund structures. The Group recommends that Member States treat private equity funds, which are used to pool assets for investment in private equity investment programmes, in the same way as they treat public equity investments. In particular, Member States in which private equity funds employ managers to manage local investments, should not use this local presence to claim jurisdiction over capital gains accruing to the fund.

³ Institutions for Occupations Retirement Provision (or "Pension Fund Directive")

Cross border placement of private equity funds

- ❖ The Group would encourage the Commission and Member States to consider a number of steps that could improve the situation for EU private equity managers seeking to sell their products in other Member States. What is needed is a common understanding of what constitutes private placement; who this may apply to; and how one may qualify for such treatment. The basic premise of a private placement regime is that regulation should not encroach on negotiated relationships between private entities, where the contracting parties are capable of understanding the nature of the bargain, including any attendant risks. A second aspect of private placement regimes is that any solicitation or negotiation takes place on a restricted and non-public basis. The Expert Group encourages EU institutions and Member States to consider establishing – in non-legislative form – a common understanding of the parameters of "private placement". This could involve building on, with adaptation in relation to experience/dealing frequency, useful provisions of existing Community law as regards the notion of "qualified investors" which can be approached without triggering mandatory disclosure or conduct of business rules.

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1. WHAT IS PRIVATE EQUITY?

1.1 Why a report on private equity?

The creation of a truly integrated single European market for financial services has been a long-standing strategic objective of the European Union. The European Commission is currently looking into ways in which it can further enhance the framework for financial services firms operating across borders in the EU and facilitate the development of European businesses. The European Commission's White Paper on Financial Services Policy 2005-10 states, inter alia, that: "a better functioning risk capital market is needed to promote new and innovative firms and to raise economic growth..., the identification of priorities for any further initiatives in the area of venture capital will be of immense importance and a clear priority for the Commission in the next 5 years". With this report, the Group takes up the challenge of proposing initiatives contributing to achieving this objective.

This report argues that there is a need for a greater appreciation and understanding in many Member States of the function, role, and potential of the private equity industry as a contributor to economic growth, and a facilitator of innovative, competitive and successful businesses. One of the core objectives of this report is therefore to address this issue from the perspective of the private equity manager/adviser or venture capitalist. The industry could make a greater contribution than it currently does if the environment were more favourable. This report will provide the European Commission, and other policymakers, with a set of recommendations on what could usefully, proportionately, and within the shortest possible timeframes, be done in order to facilitate the development of the internal market for European private equity. It will also signal far reaching objectives which the Group thinks could be taken up by Member States.

This report has three objectives:

- 1) to explain what the private equity industry is;
- 2) to explain the function of private equity in the EU economy and the contribution the industry makes to EU economic growth; and
- 3) to highlight to policymakers certain barriers which hold back the development of the European private equity industry on a cross border basis.

This does not aim to be a comprehensive report on all aspects of private equity markets. It primarily focuses on European issues which affect the EU private equity fund manager. Other important issues will also be highlighted (references for further reading can be found at the end of the report). The report is "evidence-based" and provides practical recommendations on how the EU situation can be improved. It responds to the EU's Lisbon objectives of stimulating growth and jobs.

1.2 Context

Since its emergence in Europe in the 1980s, private equity has been regarded very much as a niche player in the broader European global financial sector. But rapid development over the last 10 years, which includes the peak and trough of the dot.com bubble and its subsequent recovery, is starting to challenge this view. Growth between 2002 and 2005 in terms of assets under management has raised this asset class to above pre dot.com levels and onto the radar screen of a broader range of investors. It has also attracted the attention of national and European policymakers, and of regulators.

Private equity, as an asset class, is probably one of the less well understood segments of today's financial markets. It is certainly one of the most specialised. Private equity investments in companies can involve considerable risk at an individual company level – but are broadly comparable with other asset classes at the

portfolio level. Private equity investments can offer substantial potential awards to investors.

This report will address a number of important issues that the industry faces today; it will highlight some of the problems of doing business in the EU, but will also refer to good practices which could be used with advantage in other markets.

Private equity is a specific, separate part of the overall asset management industry. Investments in private equity are treated by institutional investors in more developed markets as falling within their overall equity allocation limits, while institutional investors in less developed markets are in many cases prohibited (according to domestic law) from investing in this asset class.

For investors, the attraction of private equity lies in the potential (risk-adjusted) performance of such investments relative to quoted equity. Such performance is the direct consequence of creating sustainable value through taking more direct and long term influence in investee companies than public equity investments allow. It is the more active entrepreneurial ability to create value in the interim period which is the real core of private equity's attraction.

1.3 Defining characteristics of the European Private Equity industry

The private equity industry is a coin with two sides. On one side, private equity is the process of collecting capital from sophisticated investors and pooling them in investment vehicles (usually called funds). On the other side is the investing side of the industry.

Private equity is the provision of capital and management expertise to companies in order to create value and subsequently, with a clear view to an exit, generate capital gains after a medium to long holding period. In Europe the terms "venture capital" and "private equity" or "risk capital" are often used interchangeably. For the purposes of this document, Private equity is used as the generic term to encompass all the sub-sets of financing stages. These include three main sub-categories (1) **venture capital** for start-up businesses and early stage companies; (2) later stage **expansion capital**; and (3) **management buy-outs** and management buy-ins. Each market segment corresponds to specific company profiles or situations and uses differing financial structures and has different holding periods. In this report, expansion capital is considered to fall under the heading of venture capital. The report will distinguish between the venture capital and buy-out markets but will not refer separately to expansion capital.

Table: Differences in terminology between Europe and the United States

	The Private Equity industry		
Europe	Venture Capital	Expansion Capital	Buy-outs
United States	Venture Capital		Private Equity

Table: The European private equity industry

Private Equity	<p>Venture Capital</p> <p>Venture capital is focussed on young, entrepreneurial companies and is an essential part of value creation in the whole private equity financing cycle. It provides finance for start-ups- at their inception or shortly after their first technical or commercial developments. Much of this segment is technology-related in e.g. new information and communication technologies, life sciences and healthcare, electronics and new materials industries. Investments are often in individual minority shareholdings with a number of venture capital funds investing alongside each other in successive rounds of financing. The investors are closely involved in determining the investee company's strategy, hiring key employees, organising the search for further financial resources and negotiating partnerships with larger corporations.</p>
	<p>Expansion Capital</p> <p>In later stage expansion (or growth) capital finance is provided to purchase holdings in existing, generally profitable companies by subscribing new capital (as equity or quasi-equity). Investee companies here have growth profiles that necessitate the consolidation of their financial structures to e.g. develop new products or services, set up a foreign subsidiary, make an acquisition or increase their capacity.</p>
	<p>Buy-out Capital</p> <p>Buy-outs are typically majority investments made in companies together with existing management (management buy-out or "MBO") or with a new management team (management buy-in or "MBI"). These normally use sophisticated financial techniques that involve bank financing. Opportunities for buy-outs are created from the sale of family-owned businesses, the sale of a non-core subsidiary by a large corporation, taking a listed company private and the sale by financial shareholders. Buy-out funds do not focus on any one industry, though most managers have sector specialisms.</p>

Typical characteristics of the Private Equity industry

1. Investment by a dedicated professional team predominantly in unquoted companies;
2. Involving active ownership driving value creation;
3. Drawing capital from a defined pool;
4. Negotiated contractual relationship with qualified/professional investors;
5. Profit-sharing schemes which align interests with investors;
6. Strong self-regulation with defined reporting and valuation requirements;
7. Involving stand-alone management of each individual company
8. Investing on the basis of a medium to long term strategy and holding period;
9. With a focus on financial gain through exit by sale or flotation.

Dedicated professional investment [management] team⁴: A private equity investment [management] team (i.e. a private equity fund manager) creates value by working with, or taking over, the companies which it invests in over a relatively long holding period (typically 3 to 5 years or more). The fund manager typically has a significant influence over its investee companies and their management teams and strategies. A private equity manager consists of specialist professionals who are close to the operational life of the investee company and monitors its progress carefully and contribute to creating value. Its objective is to maximise the investee companies' value and generate a return for its investors by sale or flotation at an appropriate time.

Active ownership driving value creation and corporate governance: Active ownership drives value creation across the whole spectrum of private equity investment and profit improvement and/or business growth are essential components in achieving returns. Investee companies are painstakingly analysed, supervised and challenged to grow and improve from before the transaction to the final exit.

Defined pool of capital: Most private equity investment is channelled through an investment vehicle in the form of an independent, private, fixed-life, closed-end fund. These funds typically have a life of ten years that can be extended upon agreement with their investors. The amount of capital is usually fixed for the life of the fund at inception. After the fund raising period is completed the fund is closed to new investors. The fund itself invests, based on a pre-agreed strategy, in a series of underlying companies to produce a diversified portfolio for its investors.

Informed, professional investors: Investors in European private equity funds are for the large part institutional investors - pension funds, insurance companies and banks. Together, these accounted for 85% of the investors in private

equity funds over the period 2000-2005. Endowments and family offices are also important and there is increasing interest from high net worth individuals. All these investors, whether institutional or individual, are regarded as "professional". They are all capable of making independent investment decisions and understanding the risks related to those decisions. Fund of funds is an increasing access route particularly for smaller institutions. The limited amount of retail investment is served through quoted vehicles - particularly in the UK where there are a number of vehicles available. There is also an increasing amount of Corporate Venturing activity and informal provision of Venture funding through "business angels" who are wealthy individuals with business experience.

Negotiated contractual relationship with investors: The contractual terms of these funds are the result of a direct negotiated relationship between the investors and the fund's management team which seek to align interests with investors. These terms include the management team's capital contribution (normally 1% of capital) and "carried interest" which is the profit share (normally 20%) they receive after investors have received a return on their capital. Management fees on assets under management vary between 1.5% and 2.5% per annum depending on the size and strategy of the fund. Typically, they are at the higher end of this range for venture capital funds which have smaller and very labour-intensive investments and at the lower end for very large Buy-out funds.

Profit-sharing schemes which align manager interests with those of investors: The private equity fund manager only receives its "carried interest" profit share once its investors have received their original capital and share of profit. This is normally not before the fifth or sixth year of the fund's life. There are elaborate "clawback" and escrow arrangements to align interests and ensure that each stakeholder in the fund gets its contractual share in the capital gain at the time of liquidation of the fund.

There is also an alignment of interests between the fund and the managers of investee

⁴ private equity managers here includes private equity advisors, since many private equity teams are structured as advisors

companies. Incentive structures in private equity backed companies can often be better aligned than in public companies, management and ownership being intimately combined at the Board table. The principle focus is not on short term quarterly performance targets, under pressure from the market, but on longer term perspective and growth. The longer time horizon for each investment enables managers to make decisions based on longer term profitability than short term share price – shareholder sentiment affects company value to a lesser extent.

Strong self-regulation with defined reporting and valuation requirements: Private equity managers produce regular (at least half-yearly) reports detailing the progress and performance of investments. There is normally a confidentiality agreement with investors to ensure “private” information relating to portfolio companies is not disclosed in a manner which could be harmful to investee companies. Unlike investments in publicly traded securities where there are well-defined prices, valuation of private equity investments is performed on a periodic basis (usually once each quarter). In Europe almost all funds use the harmonised “International” valuation guidelines which provide a framework for determining valuations based on IFRS “fair value” accounting concepts.

Stand-alone management of each individual company: Each investment has a stand-alone independent management team which is incentivised with equity or quasi equity stakes which bring them, as well as the fund managers and their investors, a share of the profits directly related to the value created in the “exit”.

Medium to long term strategy and holding period: The private equity manager virtually always invests to a medium to long term holding strategy. The typical holding period for a later stage investment is 3 to 5 years based on the team’s strategy and business plan for developing and creating value in the business. In early stage and technology investing, holding periods are frequently longer (5 to 7 years or more).

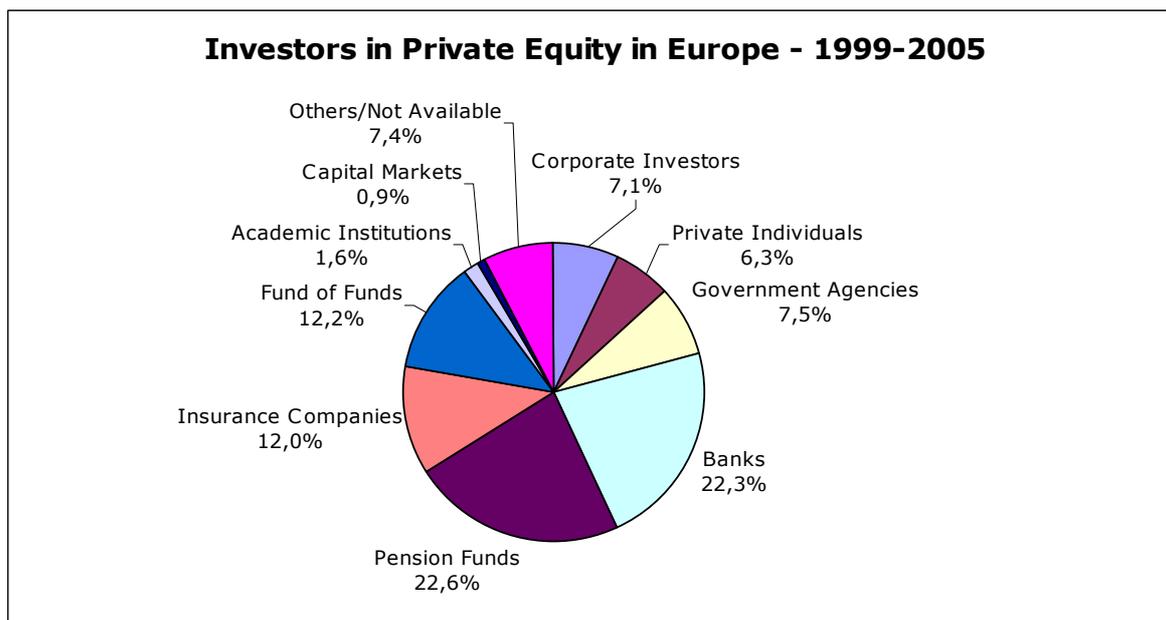
Focus on value creation and financial gain through exit by sale or flotation: A distinguishing feature of private equity is that the financial reward of the investors, the investment management team and the investee company’s management will largely come from value creation realised when exiting (by sale or flotation) the individual company investments in the fund portfolio. An important part of the investment management team’s/private equity manager’s strategy is therefore the early identification of alternative routes for exiting their investments.

In general private equity investments are not readily tradeable. To that extent, commitments to a private equity fund are usually commitments until the end of the fund’s life. So, private equity investments are often regarded as illiquid. However, an investor’s holding in a private equity fund can be exited in a privately negotiated “secondary” transaction; this “secondary market” is increasingly active and enables an investor to exit if he finds himself unable to hold the fund to maturity.

1.4. The importance of Private Equity

A large portion of the investors in private equity are represented by institutions that are actively involved in the provision of long term savings for future retirement provision.

In particular pension funds, banks, insurance companies but also endowment funds are active investors in private equity. Because of a lack of in-house resources/specialist expertise these investors usually delegate the investment activity in terms of investment selection, investment execution and investment management to professional private equity managers/firms. These firms have specialised at particular stages of the private equity spectrum. They have developed appropriate expertise and know-how given the different forms of the necessary value creation process



Source: EVCA Yearbook produced by EVCA/Thomson Venture Economics and PricewaterhouseCoopers

The decision by institutional investors to invest in private equity is based on the investor's desire to optimise its investment returns within the context of its own portfolio risk approach, and for the many institutions managing long term savings or pension's assets, their asset-liability matching requirements within consistent long term returns. The long term business model horizon of private equity fits in the long term objectives of many retirement money managers. Generally speaking the large institutional sources of capital, because of their particular mandate to provide for future savings and income, are by nature conservative. Because of the developed professionalism and institutionalised characteristics of the private equity industry and its managers, these conservative investors have started to allocate increasingly large percentages of their funds to the private equity asset class.

The success of the private equity industry depends on being able to demonstrate that its investment activity on balance creates positive appropriate risk-adjusted investment returns. Those who do not achieve this promise will not be able to survive over time.

Although equity cultures all vary considerably within the EU, it is in the interest of a thriving

economy to support a highly developed equity culture. Private equity's role within that equity culture lies in channelling available equity capital to companies that cannot avail themselves of the public equity markets. Private equity also enables companies, which find success under the spotlight of public capital markets difficult, to "privatise" and enter the private equity domain. This is particularly significant for companies facing transformational challenges in order to be able to survive. Through its function of mobilising private capital from investors, diversifying individual investment risk through portfolio orientated fund structures and allocating funds to the most potentially productive uses, private equity fulfils an important role in the overall capital market. Private equity's success in its function of supporting change at both the early stage as well as the mature stage end of the corporate spectrum is an important contributor to a country's overall economic success.

Specific economic function of Venture capital: Venture capital investment involves real risk, through investment in new technologies and/or, unproven business strategies. Venture capital investment fosters innovation by financing young companies with innovative concepts, and generates high-skilled jobs. Venture capital

investment creates new employment and new wealth. The venture capital industry represents a transmission channel of privately available capital into sectors of the economy that have no access to the public capital markets.

Specific economic function of Expansion capital:
Expansion stage investment involves less risk than venture capital and invests in existing, generally profitable, companies. It can provide capital for new premises, plant and equipment and product or service development needed for growth and in addition support the internationalisation process and the adoption of advanced governance and management skills.

Specific economic function of Buy-out capital:
Buy-out investment involves less individual company risk by investing in mature established companies where there is the possibility to create value, mainly through optimisation of businesses (sales growth, profit improvement or for instance strategic repositioning) or restructuring operations. Buy-out investment contributes to solving corporate succession situations and finances ownership transfers. It also supports profitable change in businesses which are otherwise uncompetitive and/or underperforming.

Private Equity's contribution to creating jobs:
In 2004 private equity financed companies employed almost 6 million people in Europe. This represents c.3% of the [200million] economically active population in Europe. Each stage of investment has its own particular role and contribution to make to the overall employment created by the asset class. For all investment stages, the employment growth rate exceeds the annual growth rate of total European employment over the same time period. This is demonstrated by a survey commissioned by the EVCA in 2005, aiming to explore the industry's contribution to European job creation. It indicates that the private equity industry can make a difference to the economy by increasing the level of employment in companies backed by private equity funds.

Box: Examples of job creation

Net employment growth in buy-out financed companies in the EU rose by a weighted average of 2.4% annually between 2001 and 2004⁵. Buy-out transactions of family businesses show the highest employment growth with an average of 7% per year following investment. Employment in venture capital backed in the EU companies grew yearly by 30% over the same period to 630,000 new jobs.

Further studies carried out in different Member States and the US reinforces this, not only for venture capital but also for buy-out. In the UK⁶, the second largest market for private equity investment fund management in the world, during the 5 year period to 2003/4 the average private equity backed companies increased staff levels by an average of 20% per annum, compared with a national growth rate of 0.6% per annum. During the same period annual sales growth rates at private equity backed companies rose on average⁷ 23% per annum. That is more than twice that of FTSE 100 or FTSE mid-250 companies (at 10%).

According to research⁸ by PwC and Italian venture capital association (AIFI) private equity backed companies in Italy increased their number of employees at faster rate than other similar sized Italian industrial companies, on average at a rate of 8.4%, against a national employment growth rate of 1.1%, between 2002 and 2004. Revenue growth and EBITDA also grew by a comparatively bigger proportion than similar non-private equity backed companies. Revenues rose over the period analysed by a weighted average of 17.7% (from 8.1 billion in the first year of the investment to 10.2 billion in the year of exit).

EVCA research in the buy-out market also indicates higher annual growth rates for both revenues and employment among buy-out financed-companies when compared with non buy-out-financed companies (1998–2003). Transferring company ownership from one generation to another poses problems for the growth of the EU economy – however EVCA research suggests that subsequent to the introduction of private equity financing family owned businesses that were surveyed increased

⁵ Source: EVCA. By contrast; the average annual growth rate in employment in the EU 25 was 0.7% between 2000 to 2004.

⁶ Source: BVCA

⁷ 2004 survey commissioned by the BVCA, undertaken by IE consulting

⁸ Source: “The Economic Impact of Private Equity and Venture Capital in Italy8”, PwC/Aifi, March 2006.

turnover and employment levels. The buy-out community can provide a real solution⁹ to some of these businesses by actively investing in and supporting the growth of these companies.

Private Equity financing increases the competitiveness of EU firms: Private equity firms supply companies with management expertise as well as financing. They provide support and access to international networks. Many of the bigger players are able to offer firms international market analysis of the competitive environment – crucial for potentially international businesses to take stock of the global market at an early stage in their development. Alternatively, private equity can help existing companies to develop strategic options for further developing profitability and growth.

According to research¹⁰ undertaken by Deutsche Bundesbank, venture capital contributes to economic growth through the introduction of new products and processes on the market, and the development of an improved absorptive capacity of the knowledge generated by private and public research institutions. Venture capital improves the “crystallisation” of knowledge into new products and processes. According to their estimates, venture capital must be considered as an additional “link” explaining variations in economic performances. These results therefore call for innovative policy instruments that would stimulate the participation of private venture capital funds available in the market”.

The private equity financing cycle: A European framework which facilitates the efficient development of each link in the financing lifecycle for businesses is critical¹¹ for maintaining and improving the competitiveness of European companies and the European private equity market as a whole. From an economic perspective, the profits generated are important, but should not be seen as the end game. The key point is that successful

⁹ EVCA paper: "the contribution of private equity to the succession of family businesses in Europe".

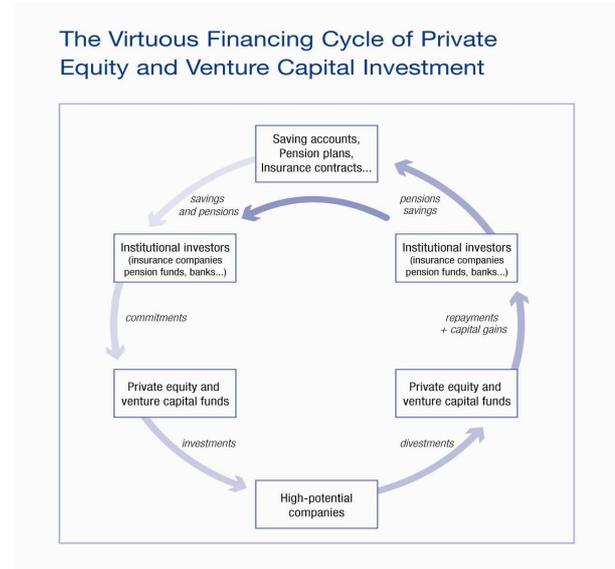
¹⁰ Source: Studies of the Economic Research Centre No 18/2004, H. Herrmann, T. Liebig, K-H Tödter

¹¹ The Group also notes that the Commission has recently published Communication on "Financing SME growth - the European way".

investment returns are passed to institutional investors that manage household savings, which can later be paid out to citizens. The returns generated by private equity funds can make an important contribution to financing the retirement savings of Europe's ageing population.

Furthermore, the private equity industry also invests in companies which can demonstrate, or have the potential, for generating steady and sustainable cash flows. While such companies might not be considered to be "high potential" companies, the financing provided to these businesses also makes an important contribution to European economic prosperity.

Chart: The financing cycle¹²



Development of governance concepts in portfolio companies: Private equity financing improves corporate governance in companies. The involvement of a private equity fund manager, either in the early stages of the company development, or in an existing private company, sets a level of discipline that does well by the company in future years – whether they remain privately owned or raise capital from the public markets. For instance, research¹³ undertaken in 2006 supports the hypothesis that the stronger the private equity influence over

¹² Source: EVCA

¹³ By the Universities of Gent/Hamburg/Nottingham, and supported by the EVCA and the Deutsches VC Institut

the investee company, the better will be the corporate governance quality in the portfolio company.

Preparing companies for public markets: There are a number of routes to exit from private equity investments. Many companies are sold to strategic buyers that integrate the company into their larger business and may therefore capitalise on synergies and/or potential for international expansion. However, flotation of the company via an Initial Public Offering (IPO) or the listing of the company on a regulated market deserves particular attention. Through the IPO and the listing on a regulated market other investors, including retail investors, are offered the opportunity to invest in companies with interesting prospects of development and growth. As mentioned earlier, the role of the private equity manager in developing corporate governance in investee firms helps those companies to be well prepared for higher levels of systems, controls and risk management processes that are required for companies admitted to public trading on regulated markets. Furthermore, research undertaken in 2006 by Oxera (in association with the London Stock Exchange and the British Venture Capital Association) on the London stock markets indicates that over the course of one year following flotation (analysing the years 1998 and 2001–04; excluding the bubble years), the private equity-backed IPOs tended to outperform other IPOs. Private equity-backed returns were 15.2% (unweighted) and 13.8% (weighted). In comparison, the one-year returns of the other IPOs were 6.1% and –1.9%, respectively.

1.5. How is the EU market developing?

Significant growth in global fundraising

The global private equity industry is still heavily concentrated in two economies, the US and the UK. The US market is still by far the most mature and developed and accounts for approximately 75% of the funds raised in the period 1983-2005 (€990bn).

However, Europe (including the UK) accounts for a large part of the remaining private equity transactions. European funds in the same period raised €350bn. 55% of the global total (€550bn) has been raised in the last 5 years with Europe seeing a surge in fundraising in 2005 (€72bn) following a difficult fundraising period from 2002 to 2004.

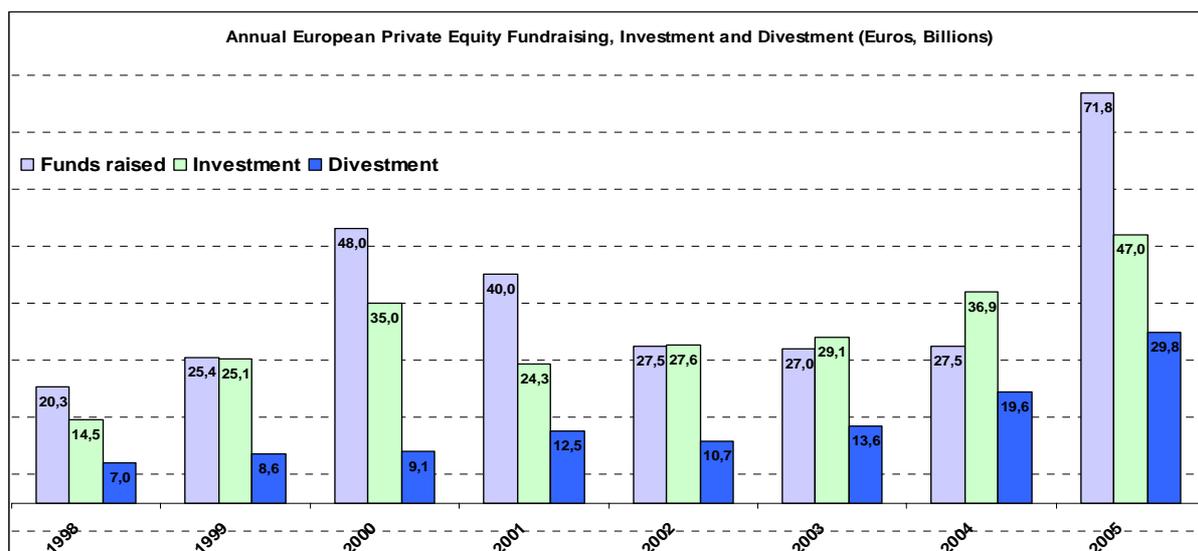
In Europe the proportion of buy-out funds raised has continued to increase in recent years reaching over 80% of total funds raised in 2005. In contrast while, in real terms, the amounts raised for early stage investments has increased they still only represent 6% of funds raised,

This highlights the comparatively difficult position of venture capital managers in recent years, caused by the ‘bubble’ of 2000, and the wider downturn in the EU economy at that time. Although the top European venture capital funds have performed to a similar level to their US counterparts (where the market is more mature), a wider recovery may take some time because of the longer holding periods necessary for venture investments.

Since the bubble, venture capital managers in Europe, in particular Europe's smaller markets, have found it more difficult to raise funds as a result of historic underperformance. This situation is likely to persist until consistent performance is delivered. However, recent substantial exits of European venture capital backed companies like CSR, Skype, and Q-cells offer some cause for optimism. These examples show that venture capital can be an extremely important driver for innovation and growth and hence it is an area that needs further support.

The following chart demonstrates that fundraising and investment are overall in balance with supply ahead of demand in buy-outs in 2005 but demand exceeding supply in the venture segment.

Chart: The European market for Private Equity, 1998-2005



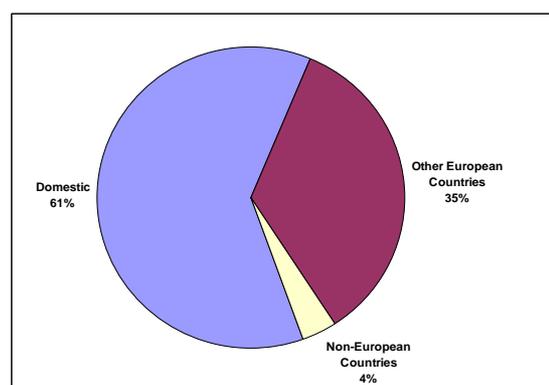
Source: European Private Equity survey, Thompson Financial and PwC

Historically, funds raised in Europe were largely comprised of local investors and as a result few structuring problems arose. However, over the course of the last decade, there has been an increasing tendency for inflows from the European Union and other countries, especially the US. Today, around half the funds raised by European private equity and venture capital funds come from outside the EU Member State concerned.

On the investment side, this trend clearly reflects the present geographical proximity of the fund management company to the investee companies. In 2005 62% by amount of private equity investment (and 86% by number) were made within the country where the management company was located. 35% of investments by amount (and 12% by number) were cross-border within Europe and the remaining balance elsewhere.

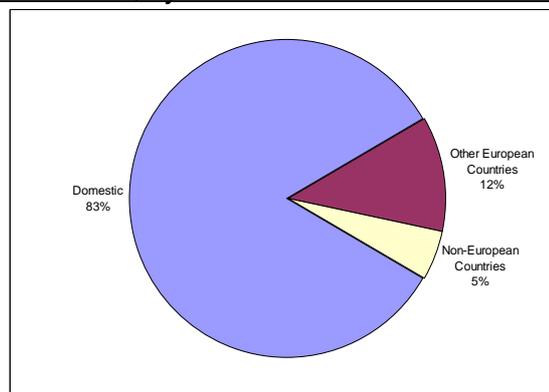
Outside the UK, this suggests a large domestic bias which is anomalous in a single European marketplace. This underlines the importance of providing the management companies with the right framework to attract international money to the country and to facilitate cross-border investing. This suggests that there is considerable scope for development and growth.

Chart: Geographical¹⁴ distribution of European investment, by amount of investment in 2005



Source: EVCA Yearbook produced by EVCA/Thomson Venture Economics and PricewaterhouseCoopers

Chart: Geographical distribution of European investment, by number of investments in 2005



In terms of concentration of management, the private equity industry as a whole remains

¹⁴ These statistics do not cover the newly joined EU Member States

relatively fragmented compared with other financial services sectors both in the US and Europe. In Europe the top 10 teams account for 22% of the total capital raised in 2001-5 and the top 20 teams 35% of the total. The top 39 teams raised 50% of the total capital.

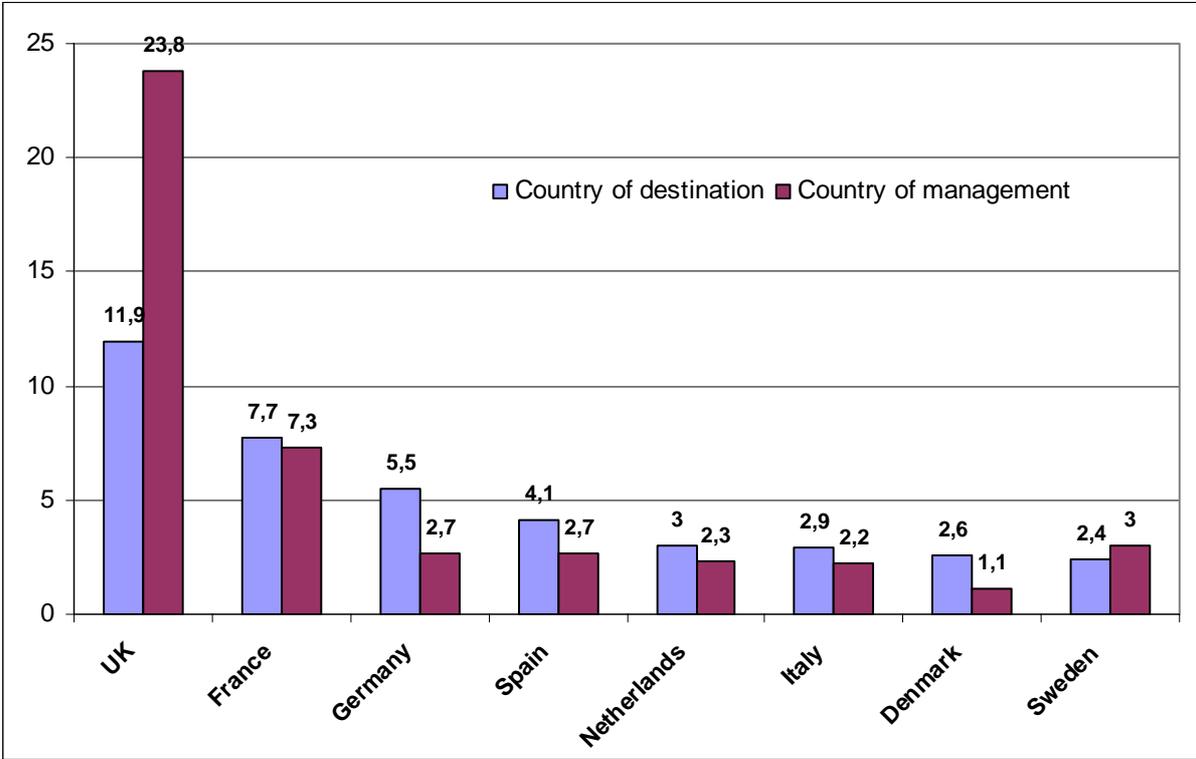
Increasingly transnational nature of the private equity marketplace

It is important to recognise the increasingly transnational nature of the private equity marketplace and the way teams manage money

reflecting the increasing internationalisation of businesses in which they invest. A number of US groups, both in the buy-out and venture space, now have teams operating in Europe and are mainly based in the UK.

The following chart demonstrates the significant differences between the domicile of the management team and the geographical destination of investments, as measured by the domicile of the underlying companies (whose businesses themselves are increasingly transnational).

Chart: Country of destination of investment (€ billions) & Location of fund management team (assets under management, € billions), Top 8 EU Member States in 2005



Source; European Private Equity survey, Thompson Financial and PwC

The apparent dominance of the UK in this is because the larger pan-European funds are almost invariably headquartered in London.

Financial returns from private equity investment

Private equity performance compares favourably to other asset classes. There is very

clear evidence that “top quartile” funds significantly outperform public equity markets. There are differences in performance in the differing market segments. In particular the buy-out market has consistently outperformed whereas venture capital has not always lived up to expectations for many structural reasons.

Chart: European private equity performance (combining all data since records began)

Investment Stage	EU total return pooled, IRR	Top Quarter*, IRR	Upper Quartile, IRR	Morgan Stanley Euro Index, IRR	HSBC Small Company index, IRR
Early stage	0,1	13,6	2,3	4,2	10
Development	9,2	18,8	9	8,4	10,3
Balanced	8,3	23,7	8,5	6,3	9,9
All venture capital	6,3	17,1	6,2	6,4	9,8
Buy-outs	13,7	31,8	17,8	2,7	8,7
Generalist	8,6	10,3	8,8	7,4	9,7
All Private Equity	10,3	22,9	10,6	2,3	9,7

Source; Source: EVCA/Thomson Venture Economics/PricewaterhouseCoopers presented in EVCA Symposium, June 2006

*the top quarter Internal Rate of Return (IRR, cf footnote 16) is the pooled returns of funds above the upper quartile

The Need for Diversification to Mitigate Risk

At the individual investee company level a private equity investment is inherently risky. Failures, where they do occur, tend to happen in the first few years of a private equity fund's life, before returns from the better performing investments come through. Early losses in the first few years of the life a private equity fund also corresponds to the period in which investments are being made (and include associated start up costs and management fees).

When the first realisations are made, the fund returns start to rise quite steeply. In buy-outs after about three to five years, the internal rate of return will give a reasonable indication of the definitive rate of return. This period is generally much longer for early-stage and expansion funds. Extensive research has shown that, provided investors build properly diversified portfolios - just as they need to for public equities- the potential for total loss is extremely low. This diversification is normally achieved over time by investing in a series of funds specialising in different segments and regional locations. Research commissioned by the European Investment Fund measures the risk associated with direct, fund, and fund of fund investments in private equity by comparing the entry and exit prices of an investment. It concludes that while at the individual investee company level a private equity investment is

inherently risky, a fund (i.e. a portfolio of direct investments) has a very small probability of total loss because it will manage on average between 10 and 20 individual investments. Furthermore a fund of private equity funds (i.e. a portfolio of private equity funds) has a very low probability of any loss at all as diversification is achieved at both the level of the portfolio, and within the underlying private equity funds themselves.

What are current trends and future prospects for the private equity industry?

The trend to asset-liability modelling has particularly drawn attention to the attractiveness of private equity and its "fit" with the longer term nature of pension fund and insurance liabilities. This has led to increasing allocations to private equity assets by many organisations, notably pension funds but also foundations and endowments over the last decade. According to industry research¹⁵ in the US, up to 7% of these investors' asset allocations goes to private equity assets and in Europe the corresponding figure is 4.5%. Although this data does not cover the whole spectrum of institutional investors, as they exclude investment funds and insurance companies, the figures are still representative enough. Even if, as a whole, institutional investors' allocation to

¹⁵ Source: "The 2005-2006 Russell Survey on Alternative Investment" by Russell Research of the Russell Investment Group, 2005

private equity should be lower than the figures quoted, the data shows that the level of asset allocation to private equity is increasing.

In Europe, private equity is expected to continue to grow and represent a fundamental element in corporate restructuring and increase competitiveness of EU companies. The increasing globalisation of financial markets will expose EU private equity to international competition and the creation of a favourable environment is fundamental to allow European players to compete in such a diversified and internationalised industry.

- This will be sustained by a continuing increase of available assets under management as institutional investors seek out superior returns and recognise the advantages and efficiencies of private ownership. There will continue to be growth in terms of weighting of overall allocation from institutional investors and other eligible investors to this asset class.
- As financial markets become more global, further exploration of the equity component of private transactions is likely to follow. As the scale of activity and transaction sizes increase, private equity will continue to explore the territory of companies which were formerly in the domain of the public markets.
- In an increasingly competitive and globalising business environment, private equity managers may continue to develop even further their transnational operations, either as part of the same firm or through networks of private equity managers.
- The industry, as a whole, is likely to reinforce its specialisation and segmentation with regard to sector focus and investment stages, focusing more on the later stage and buy-out segments. There may be an emerging “bulge bracket” of top buy-out teams which will manage individual funds in excess of €10bn and will be active on the global stage. A few large acquisitions have already taken place in the Buy-out market in EU and this is likely to develop. However

this will still represent a comparatively small proportion of overall M&A activity in the public markets in the short to medium term.

The Group expects the positive impacts of the industry on economic growth, job creation and portfolio companies' global competitiveness to continue.

2. INDUSTRY OPERATING ENVIRONMENT

2.1 Industry standards

The private equity industry has developed successfully on the basis of privately negotiated agreements undertaken between private equity fund managers and "professional" investors. The industry adheres to self-imposed industry standards which have been developed in conjunction with investors/clients. In addition to the controls agreed between managers and investors, the industry has adopted self imposed codes of conduct, encompassing all aspect of its activities, from valuation to reporting [to investors] to corporate governance principles for the management of the fund and of the portfolio companies. Adherence to these standards represents essential elements in establishing and maintaining confidence and trust between market professionals and investors.

As an example the Group highlights the importance of its industry standards in the area of transparency and disclosure.

Transparency and disclosure:

The private equity industry operates according to high levels of transparency between investors and fund managers. Confidentiality agreements between managers and investors are a typical feature of this business. They ensure that information flow is handled carefully to avoid widespread leakage of commercially sensitive material. For example, the writing-down or writing-up of a company's valuation by a private equity fund could be mis-interpreted and harm the company's competitive position as well as impede the private equity manager's ability to negotiate an exit valuation. Valuation changes are often made due to a change in market valuation metrics, such as stock market multiples, rather than

an individual company's longer-term performance and prospects. If not correctly understood, disclosed performance figures could lead to the drawing of wrong conclusions by those not familiar with the asset class. Particularly important here is the "J-curve"¹⁶ effect of a private equity investment fund life cycle, which makes internal rates of return in the early years of a fund's life meaningless and does not serve as any kind of indicator to the funds longer term performance expectations. Public disclosure of portfolio company performance (i.e. financial statements or editorial comments on the company's evolution) could severely impact the company's ability to compete by making highly sensitive information available to competitors.

The European situation for private equity is characterised by the application of professional standards on performance measurement, reporting, valuation and governing principles. Managers are conscious of the need to behave responsibly both as shareholders and because of their fiduciary responsibility to their investors. The European (Private Equity and) Venture Capital Association has published general manager/investor disclosure guidelines within its reporting guidelines (2006) and valuation guidelines (2005).

2.2 Broader policy perspectives

In order to develop well functioning, efficient and competitive private equity markets in Europe a wide range of interacting elements need to be in place. The world's best markets for private equity have similar economic characteristics – stable regulatory environments, liberal policies towards enterprise, well-funded financial systems and an appetite and support for entrepreneurship.

¹⁶ The return pattern of private equity and venture capital funds is specific to the asset class. Investments in private equity tend to lose value during the first years of investment and increase steeply after the fund has reached maturity, i.e., after it has completed the investment phase and is well into the divestment phase. Early losses in the first few years of the life a private equity fund – expressed as negative Internal Rates of Return (IRR) – are normal and do not necessarily reflect a lack of profitability of the private equity fund. They correspond to the period in which investments are being made in portfolio companies (from the investor's perspective cash-flows are negative because downs are being made and management fees being paid).

A recent report¹⁷ by the Economist Intelligence Unit (EIU) highlights that there are a number of key levers that Member States may use to develop their national private equity markets. The Group believes all of these are areas that need to be considered, and indeed are subjects of debate and national reforms by Member States and also by EU policymakers. On the basis of these criteria the EIU and Apax Partners developed a benchmarking survey. The survey places only the UK, Denmark, Sweden and Belgium in the top 10 in the world. These levers are not mutually exclusive, nor collectively exhaustive, but may be grouped under the following headings:

- ❖ **Overall environment for private enterprises** (including level of bureaucracy, openness and fairness of the competitive landscape)
- ❖ **Financial environment** (including its quality and depth and the regulatory approach to financial markets)
- ❖ **Market opportunities** (including potential for investments and the availability of skilled labour)
- ❖ **Legal and policy environment** (including government attitude, fund formation rules and taxation)
- ❖ **Entrepreneurial environment** (including fiscal support and company law regulation)

The more developed and successful EU markets have a more private equity-friendly environment. This usually reflects a deliberate policy towards stimulating private equity, in recognition of the role and benefits to the economy of the private equity industry. The Group observes that usually private equity fundraising and investment take place where the environment is most favourable.

Member States that seize the opportunity to remove obstacles to the development of national private equity markets – for investors, for funds and for private equity fund managers – position

¹⁷ Source: Apax/Economist Intelligence Unit, 2006 - "Unlocking Global Value: Future Trends in Private Equity

themselves well to benefit from the ongoing development of the global private equity industry.

Specifically, the Group welcomes the fact that EU policy has recognised the specific challenges facing the venture capital sector. Revised rules allowing State Aid under defined conditions and intended to better reflect the reality of EU businesses and targeted towards small, innovative firms are now being put in place. This should encourage this sizeable section of the economy to develop its potential to contribute to the competitiveness of the EU economy. However, there are still inconsistencies within the SMEs definition through the Commission Recommendation of 2003, leading to depriving growth-oriented SMEs from benefiting from private equity and State Aid measures jointly.

Furthermore the Group notes that while it is an ambitious goal to harmonise Member States' policies such as entrepreneurship, the national reform programmes, by which Member States report on measures and progress with the implementation of the Growth and Jobs Strategy, will eventually contribute to some common approaches or to a similar direction.

Recommendation

The Group strongly encourages national policymakers to use the levers available to them to develop private equity finance. We would urge Member States to learn from each other and to create the optimal conditions at local/national level to facilitate the development of this important form of financing.

2.3 National regulation

The legal, tax and operating environment in which a private equity industry may develop is determined largely at national/local level. Local fiduciary relationships and obligations differ widely in the various Member States. While there is no specific EU level regime governing the regulatory approach to the private equity sector, most Member States regulate part or all

of the private equity value chain. The main areas of regulation cover

- ❖ Management of pooled investment vehicles and funds
- ❖ Placement to eligible investors
- ❖ Tax incentives and restrictions
- ❖ Funds and product terms and conditions

However the Group would highlight that this industry should not be regarded as an industry which caters for a general retail investor base. Those in the industry who have developed specific products for retail consumers (listed or not) comply with a full range of different regulatory measures enforced by regulators with a strong mandate to protect retail investors. This report focuses on the points of the industry which are dealing with eligible, professional investors (whether institutional or individual) who, through their due diligence process, are capable of making autonomous decisions and understand the risks related to those decisions.

These national regimes are not aligned. This can have a very harmful impact on the effective development of the private equity industry. In this respect, the Group would like to highlight one clear example with regard to the approach taken to regulating which institutional investors may invest in private equity funds. National restrictions range from quantitative and qualitative limits to total prohibition.

Even in cases where European legislation has introduced possibilities for a broadly consistent approach to pension fund investment in Private Equity, national implementation varies. The prudent person rule enshrined in the Institutions for Occupational Retirement Provision Directive (or "Pension Fund" Directive) should provide for the possibility to allow pension funds to include investments into private equity funds in their asset allocation according to their own needs, while respecting the risk profile of their clients.

Recommendation

The Group believes that institutional investors should not be faced with arbitrary or outdated quantitative restrictions.

The Group considers that there is a growing need for a "prudent person" concept to be applied to institutional investors across the EU. This could start with investor groupings for which such a concept already exists but which is still inconsistently implemented through national implementation of the IORP Directive¹⁸.

2.4 EU regulation

There are a number of EU Directives which affect the private equity sector, although none are specifically aimed at the private equity industry. The industry is also influenced by the Capital Requirements Directive, the IORP Directive, and the forthcoming Solvency 2 regime for insurance firms, as these latter initiatives have an impact on the way the private equity industry's investor base allocates resources and makes investments.

The Group would highlight however that some rules in particular have generated unintended consequences as a result either of their drafting or from incorrect and inappropriate transposition. Significant examples are the European Commission's definition of "SME", certain features of International Financial Reporting Standards that do not accommodate the structure of a private equity fund, and provisions in the Markets in Financial Instruments Directive.

Box: High impact unintended consequences of existing legislation

SME – Small to Medium sized Enterprises

The Commission definition of SME was revised so that an enterprise only qualifies as an SME provided that it is not 'linked' with other entities which, when taken together, exceed a certain size. The net effect is

¹⁸ Institutions for Occupational Retirement Provision (or "Pension Fund Directive")

that the Commission's stated aims of economic growth; job creation and economic and social cohesion through support for SMEs are hampered rather than advanced. The new definition¹⁹ of 'linked enterprises' works in such a way that all portfolio companies invested in by a single private equity fund are treated as linked when determining whether any one portfolio company qualifies as an SME. As a result, it is now extremely unlikely that any business invested in by a private equity fund will qualify as an SME, as the portfolio of companies taken together will generally exceed the relevant threshold. This means that small businesses that are not, in any real sense, members of a group are treated as such simply because they have sourced capital from a private equity fund. Private equity funds are more reluctant to invest in small, innovative businesses, as it is more difficult for this type of business to be profitable (and therefore an attractive investment prospect) if it does not benefit from SME support schemes. This exacerbates the problem of the finance gap, and deprives businesses of 'value added' benefits. Portfolio companies that would otherwise qualify as SMEs are put at a competitive disadvantage when compared to similar businesses that have obtained funding from other sources, such as bank loans. This distorts competition, and makes it harder for businesses that are deserving of support to succeed. These effects are becoming increasingly apparent as Member States use the definition in progressively wider circumstances. In a number of cases, the Commission has agreed to a relaxation of the definition. However, the problem remains largely unresolved.

IFRS – International Financial Reporting Standards

IFRS require an aggregation of portfolio companies, even though each is treated quite separately (in the vast majority of cases) by the fund. Here, the debate centres on whether a fund should produce consolidated accounts that consolidate the profits and losses and balance sheets of all investees. The private equity industry argues that these accounts would not provide meaningful information to investors, and could even be misleading. They would also be costly to prepare. So far the regulators have been reluctant to make an exception for private

¹⁹ According to Art.9 in Annex of the Commission Recommendation of 6 May 2003 it states that "On the basis of a review of the application of the definition contained in this Recommendation...the Commission will, if necessary, adapt the definition contained in this Recommendation, and in particular the ceilings for turnover and the balance-sheet total in order to take account of experience and economic developments in the Community".

equity because of the need for strict rules to prevent "off balance sheet" items. This is an ongoing debate that is required to be resolved. At the moment, IFRS are only compulsory in the EU for the consolidated accounts of listed companies, and so this is only an immediate concern for listed funds. However, there is a general acceptance that IFRS will - one way or another - end up applying across the board, most probably because of the commitments to converge with IFRS that most national standard setters have given.

MIFID – Markets in Financial Instruments Directive

The Markets in Financial Instruments Directive ("MiFID") does not apply to private equity firms and others which are structured as managers of collective investment undertakings. It will normally apply to the significant sections of the private equity industry which are, frequently for tax reasons, structured as advisers and deal arrangers. In those jurisdictions where investment advice has not previously been regulated it will bring many firms into European level regulation for the first time. However the detailed rules under MiFID (which are still being finalised) do not generally take account of the special features of private equity and can be inappropriate, for instance requiring the publication of best execution policies relating to the venues on which transactions are executed, which is inherently unsuitable for individually negotiated private equity transactions.

Recommendation

The Group recommends that policymakers consider the characteristics of the private equity industry when reviewing existing or drafting new legislation. Where it can reasonably be foreseen, impact assessments should take the characteristics which define the private equity industry into account to avoid the unintended impacts of EU initiatives on the private equity industry. Where the impact is intended, the policy objectives should be developed with an understanding of the key drivers of the private equity industry so that any measures will have the intended outcomes. In making this recommendation the Group acknowledges that the industry itself must do more to explain the specificities of the business clearly to a wider audience in terms that accurately capture the business objectives, structure and characteristics of the private equity industry.

The Group argues 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.

The Group recalls that funds managing smaller pools of capital are particularly affected by inappropriately drafted or targeted legislation.

3. PROBLEMS WHEN OPERATING CROSS BORDER

3.1 Introduction

The overall legal, fiscal and regulatory environment in Europe needs to facilitate each link in the financing chain of companies. The private equity industry performs an important role in assisting entrepreneurs. The very different national approaches to regulation and the resulting legal fragmentation result in high operating costs and high administrative and legal fees for those funds. Small or medium-size funds are penalised more than big ones and are deterred from developing cross-border operations.

The EU has set itself the goal of building a competitive, knowledge based economy, capable of nurturing and sustaining world class companies. A true Single Market based on the free movement of capital, goods and services is crucial to the realisation of that vision. This policy recipe should also be put to work for private equity which is not the case today. We regard the areas of fund structuring and selling funds across borders as areas where important steps can be taken at a European level to facilitate the further development of the European private equity industry. This would allow the industry to leverage its role in developing companies in the EU and deliver meaningful financial returns to investors in this asset class. It would be able to invest more across Member States and appoint local management to act for the funds in the other Member States where the funds invest.

3.2 Fund structuring

The structuring of a private equity fund is driven exclusively by the needs of its investors. Paramount amongst those needs will be protection against liability and taxation of capital gains so as not to change the tax treatment of investors in their home country. The fund must also be capable of being marketed to suitable investors in all countries. The vast majority of private equity fund structures are based on limited partnerships in different jurisdictions. Structures are generally benchmarked against US structures. To be able to compete for commitments from limited partners, a private equity fund therefore has to have a structure comparable to a US structure in almost all respects.

Across the EU different legal and fiscal philosophies are applied to private equity financing. These differences are manifest in a range of different requirements (tax on capital gains, VAT, management charges, no deduction for losses etc.). It falls to national authorities, in the first instance, to create the right tax and legal environment for the private equity industry to thrive. National authorities should address the main sources of tax or legal shortcomings which act as a drag on the development of their local private equity industries.

This section will focus on complications which call for pan-European solutions to deal with cross-border operations. These complications arise from a failure of Member States to grant appropriate tax treatment to private equity funds established in other Member States and which seriously complicate cross-border capital-raising and investing by private equity funds. As a consequence of these complexities private equity funds have generally been advised to establish their funds offshore.

When raising capital:

A guiding principle for fund taxation is that investors should be in the same situation regardless of whether they invest in underlying assets directly or through a fund. However, Member States differ in how they apply the

conditions for treating a structure as transparent.

An example which is of particular relevance for private equity funds, concerns the failure of Member States to recognise the tax-exempt status which is conferred on overseas investors in their country of domicile. A significant proportion of private equity funds are provided by pension savings (the largest investor in 2005, representing c.25%²⁰ of total capital invested in European private equity funds) and other institutional investors which are exempt from capital gains tax when investing in their home country. However, tax exempt status may not be recognised in other countries, depending on the structure used. This can lead to an increased tax cost – or risk of higher taxes - when investing in other Member States. Any tax imposition – or even risk of tax – will penalise and ultimately discourage cross-border investment compared to investment in local vehicles.

If, for example, an exempted pension fund invests in a private equity fund that in turn makes an investment in another Member State it may be required that both the state where the private equity fund is domiciled and where the investment is made recognise the tax-exempt status of the investing pension fund. Otherwise the pension fund runs the risk of additional taxation as compared to alternative investments such as public equity. A private equity fund that intends to make cross-border investments and be a viable proposition to investors across the EU, and elsewhere, cannot compete with US private equity funds for commitments from investors if capital gains tax is incurred at the level of the fund.

Obstacles to cross-border investment by private equity funds:

Private equity funds are faced with further tax obstacles because of their reliance on local 'advisors' when managing investee companies in other Member States. As these advisors are based in the local country, providing the necessary support to the management of the investee company, it could be argued that they

²⁰ EVCA/Thompson Financial/PricewaterhouseCoopers

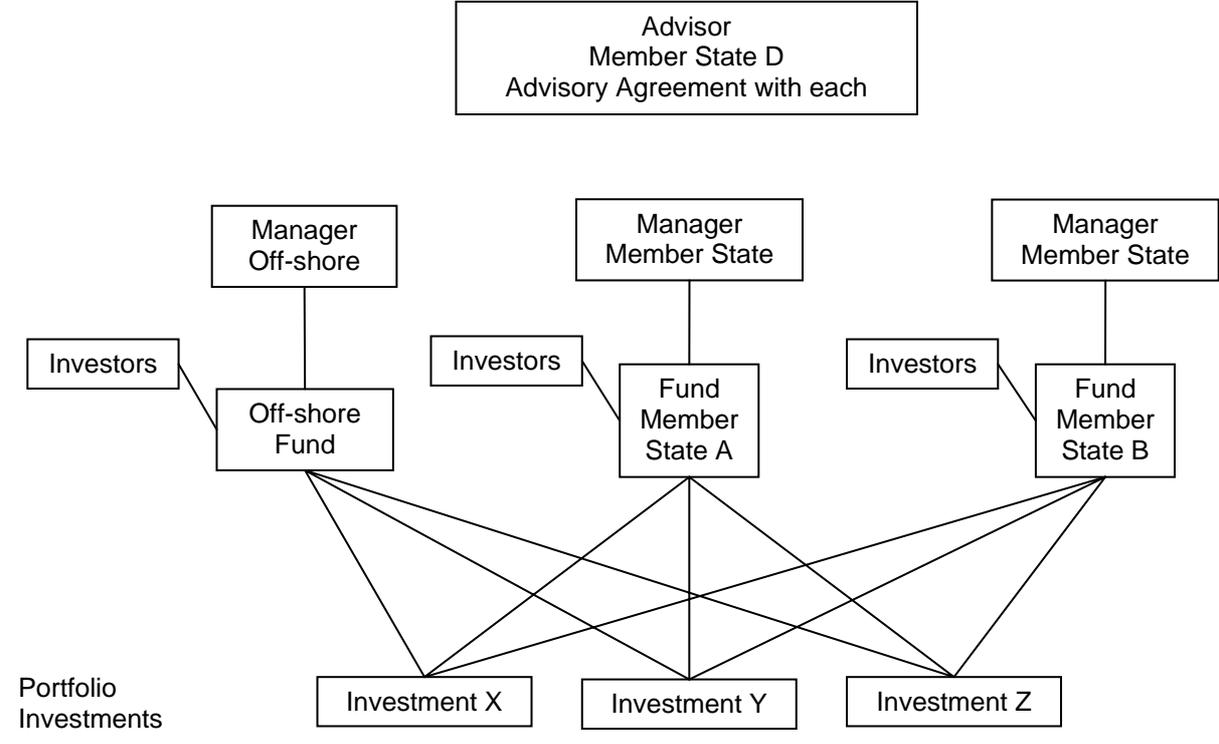
are creating a 'permanent establishment' for the fund by the local tax authorities, although the fund is usually structured to avoid this. Even though this risk might be remote, investors are reluctant to invest if it is not certain that such activity will not create any tax liability for capital gains in the local country. There is a further anomaly in that these problems do not arise in respect of investments in public equity – which are able to rely on arms-length relationships with independent local brokers managing portfolios of public investments. This situation creates an additional risk for private equity funds of being subject to capital gains tax in countries where investments are made. This is the reason why private equity funds are established off-shore. This limits the actual

activity in the local country to purely advisory services rather than actual decision making regarding the making, managing and disposing of investments. This leads to a lack of efficiency and increased costs compared to allowing the private equity fund to be managed from the local country.

What is the impact of this problem?

There is currently no fund structure within the EU that solves the problems outlined above. Instead complex structures, involving off-shore entities, are required. The following case study is a typical example of the complexities involved in structuring private equity funds in Europe.

Box: typical fund structuring arrangements for EU private equity funds



These structures are inefficient, costly, operationally complicated to construct and manage, and involve a significant amount of risk. It costs at least between €100,000 and €200,000 for each additional structure. This is estimated at up to 1% of committed capital over a fund’s lifetime. This means that despite the record fundraising period during 2005, up to €700m of the total €70bn raised in European

final closings²¹ may be absorbed by additional and potentially avoidable administrative costs. This is €700m of investors' capital (including pension funds, life companies etc) which is allocated to private equity, but which is not therefore being invested in companies. Uncertainty and risk add to the costs charged to a fund. These are ultimately passed through to institutional investors and their

²¹ Source: Almeida Capital

clients/members. The efficiency of the fund suffers as a result of these costly arrangements.

The additional costs and the additional risk associated with this serve to make the European industry less competitive than other jurisdictions (notably the US) – at a time when European and national policymakers are trying to find ways to increase the competitiveness of the EU and the attractiveness of the EU as a place to do business or invest in. Those who suffer most are the young/new fund managers and smaller funds who find it harder to spend the additional time on and to absorb the additional costs of complex structures and fund managers in markets with a small local base of investors, particularly in the new Member States. For smaller funds and venture capital funds, it is becoming difficult or almost impossible to raise money on a pan-European and international scale because of the structuring costs.

Investment in locally domiciled private equity funds is privileged over investments in funds established in other Member States. This strong domestic bias in private equity investing is not observed in other types of collective portfolio investment. It is not healthy in a market which aspires to be open, integrated and competition-driven.

There is a geographic dimension to the market distortion. The current EU environment and framework(s) favours investment and fundraising where market access is easiest, rather than purely where the best business opportunities are identified. This distorts the market and does not work to the benefit of investors or the underlying portfolio companies. There is therefore no common market in the EU for private equity funds. It is difficult, and in some cases economically unviable to raise money in certain Member States, and to make investments in others.

The end result is 25 shallow local markets, with much business gravitating towards a large offshore market whose primary purpose is to help managers and investors to avoid these local limitations – at a high price in terms of increased cost and lower efficiency.

How do we improve the situation?

This situation reflects the fact that the Member States are only now becoming aware of the wider, (positive) economic and social impact of the private equity industry and its stakeholders. The intention was almost certainly not to discriminate against private equity compared to public equity; rather their fiscal policies have simply not been amended to reflect the new situation where private equity has assumed a role previously played by public companies (R&D, investment, efficiency improvements). Instead the fiscal policies are based on general concerns regarding protection of the individual Member State's tax base for normal business income.

However, given the associated costs, it is now time for Member States to try to resolve these difficulties. In particular, it is necessary to establish a common understanding of what constitutes a fiscally transparent private equity fund structure. Only where this is achieved, will private equity funds located onshore in one Member State to be able to compete effectively with offshore structures. The Group believes that the most cost-effective and promising way to achieve this result will be through mutual recognition of the fiscally transparent fund structures that exist in the different Member States. Many Member States have already developed private equity fund structures that are used in their domestic markets.

Each Member State should treat capital gains realised in private equity funds as being taxed in the investors' home countries – even where managed by and invested in another country. This approach has already been established for investments in public equity with tax treatment based on OECD's model tax treaty. Therefore, all that is being sought is parity of treatment for private equity.

It would be useful to codify a coherent and general set of practices in this regard. In the short term each Member State should treat capital gains realised in private equity funds as realised in the investors home countries in the same manner as for public equity although managed in another country. In the long term

the Group would encourage the Commission and Member States to develop a common approach through the auspices of the OECD. The OECD has a specific mandate to facilitate co-operation in the area of international taxation. An added advantage of an OECD based approach is that the geographic reach of its work is wider than EU legislation.

Recommendation

The guiding principle for enlightened and single-market-compatible taxation of private equity funds is that the investor only be taxed in its home country on capital gains.

For capital gains tax purposes Member States should 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. The EU institutions and Member States are urged to take appropriate steps to codify the mutual recognition of each other's fiscally transparent private equity fund structures.

The Group recommends that Member States treat private equity funds, which are used to pool assets for investment in private equity investment programmes, in the same way as they treat public equity investments. In particular, Member States in which private equity funds employ managers to manage local investments, should not use this local presence to claim jurisdiction over capital gains accruing to the fund.

3.3 Marketing and selling funds across EU borders

Where do we want to get to?

Private equity fund managers look to a global investor base when raising capital for investment. EU private equity managers should not face overly burdensome restrictions when raising funds from within the European Union or when approaching potential institutional and other qualified investors across the EU.

Unfortunately this is currently not the case for a variety of reasons.

The ideal scenario for a private equity fund manager raising capital in other Member States would be to be subject to only one set of placement rules; to have legal certainty as regards the identity of eligible investors; to negotiate with investors on the basis of one form of private placement memorandum; and to pool investments into a single fiscally transparent fund structure. The Group would encourage the Commission and Member States to consider a number of steps that could improve the situation for EU private equity managers seeking to sell their products in other Member States. The Group underlines that the following discussion excludes raising capital from retail investors. Marketing to retail investors (including high net worth investors) directly is a relatively smaller segment of the market and those retail investors investing into this asset class via a listed vehicle - or private banking vehicle would already receive adequate investor protections. In 2005 over 85% of investors which invest in European private equity vehicles are institutional investors and other qualified investors who have a detailed knowledge, or sophisticated understanding of financial markets and products.

Box: National approaches to private placement

Many Member States have established national private placement regimes. The basic premise of a placement regime is that regulation should not encroach on negotiated relationships between private entities, where the contracting parties are capable of understanding the nature of the bargain, including any attendant risks. Between such investors, there is no need to impose provisions designed to protect retail investors such as conduct of business rules, risk warnings or product specifications. A second aspect of private placement regimes is that any solicitation or negotiation takes place on a restricted and non-public basis. As long as placement takes place within prescribed limits, there is deemed to be no public offer of the investment proposition and consequently no need for application of rules on marketing or publicly mandated disclosure. Once business is conducted within the parameters of the private placement regime, the contracting parties would be free from the application of conduct of business rules designed for non-expert clients, product registration

or content rules, and marketing or disclosure requirements.

Currently private placement rules vary significantly between Member States both in terms of who is eligible to invest and the products that can be promoted. Eligibility is sometimes conditioned on the "institutional" nature of the investor, sometimes by reference to a (limited) number of subscribers, or sometimes in terms of who is active in soliciting business. Finally, some regimes may limit the possibility of private placement to specific kinds of security (e.g. closed-end fund shares).

The consequences of operating inside the private placement regime also differ. In some countries, it may be limited to a waiver from the obligation to publish prospectus or other mandatory disclosures. Compliance with certain promotion rules (such as marketing techniques) may still be required. Product registration with the local authority may in some cases be required.

Where are we today?

Private equity fund managers are able to make use of these regimes to some limited extent in order to obtain access to the relevant investors. However, the differences between the different placement rules must be understood and respected when making representations to potential qualified investors in other Member States. This is not easy when these requirements are complex and often opaque. The table below highlights some of the difficulties that private equity managers encounter when seeking to raise capital from (institutional and qualified) investors within the European Union. These differences demonstrate that we are currently a long way from a single market for European Private Equity operators raising capital within the EU.

Key differences encountered when approaching investors in the EU
The need (or not) for an authorised person to carry out marketing and promotional activities of a fund or to collect money.
The need (or not) to register a local vehicle with regulatory authorities
The requirement to gain approval (or not) of

promotional documents by local regulatory authorities (the need for a prospectus similar to public offer of securities prospectus).

Rules for exemption from greatest restrictions (restricted circle, professionals' only).

Lack of (or differing) definitions of "private equity" and of "qualified investor" add confusion to the picture.

In simple terms, fund managers must traverse a legal minefield before transacting with potential investors. This legal patchwork is a major impediment to the cross-border promotion of private equity funds to professional investors. It results in acute uncertainty as regards the conditions under which investments can be concluded. The regulatory barriers and legal uncertainty impose barriers to entry to foreign managers raising funds in domestic markets and to domestic investors accessing foreign funds. Despite the successful fundraisings that have taken place in recent years, these differences restrict the amount of money that can be raised for a particular fund; they increase the cost and time to raise funds in Europe, and they increase the potential liabilities private equity fund managers can face when raising funds across Europe. Frequently, private equity fund managers therefore place restrictions on target markets during the fundraising process or take on legal risk i.e. enter markets despite regulatory constraints.

They translate into higher costs of raising money, particularly by inflating legal and advisory fees. This means a higher cost of capital, and higher hurdle rates before a profit can be achieved. The whole fund raising process not only requires preparation time but also the constraints may prolong the fundraising periods. The level of liabilities for managers can also be increased as non-compliance may lead to liabilities (potentially even on a personal basis for the manager concerned). These higher organisational costs negatively impact the returns available to investors (lower net IRRs).

Those actors which are most adversely affected are managers in smaller markets (with smaller

domestic investor base) which by definition will have to look abroad to raise capital. In addition, smaller funds (and therefore especially the venture capital market) or young managers with limited resources are disadvantaged. The larger Buy-out funds find it much easier (though no less frustrating) and are better equipped to absorb these high costs. However, it still means capital and time wasted on the fundraising process that should be put to work on developing portfolio companies.

How do we move forward?

What is needed is a common understanding of what constitutes private placement; who this may apply to; and how one may qualify for such treatment. The core features of such a regime should include:

1) A definition of eligible qualified investors which are recognised as having the capacity to contract freely in the private placement 'safe harbour'. This should include institutions and investors acting in a professional capacity. It should also include high net worth investors who are considered in the vast majority of jurisdictions as "qualified" investors due to their capacities. Another route to defining the population of eligible qualified investors might be to fix a threshold for a minimum initial consideration. We note that the US relies exclusively on a high net worth status to determine "accredited investor" status and that the UK allows certain venture capital/private equity investments to be marketed to self-certified high net worth individuals, and marketing of most types of investment to those externally certified as "sophisticated" investors even if they are not high net worth.

As regards the definition of qualified investor, the Group discussed whether any additional tests – above and beyond a high net worth test – should be employed. Should such a test be employed, it should then be appropriate and adapted to the reality of the private equity market. In this respect, a purely mechanistic test based on frequency of dealing would not be optimal given the long holding periods and illiquidity of private equity investments. The group considered that if the frequency dealing

test should be adapted to the private equity context, it should be crafted along the following lines: "X ... [confirms/demonstrates] that he is an experienced investor in the relevant market with sufficient understanding to be classified as a [qualified investor/professional client]. [Such experience may, in relation to publicly traded securities and financial instruments be demonstrated by carrying out transactions of a significant size at an average frequency of, at least, 10 per quarter over the previous four quarters.]."

Retail investors would not qualify as 'eligible investors'. Because of the illiquid and long term nature of private equity investing, capital is committed long term but called up on an unpredictable basis over a period of years – to do this an investor needs to understand the terms of the contracts, of course. Equally it is in the interests of the private equity managers to manage their credit risk and only accept investors which have a high probability of being able to fulfil their funding commitments. For this reason, mass market retail investors are either unable to meet such obligations or would be unattractive credit risks for the private equity manager to accept into the fund.

2) Rules to avoid leakage from the private placement regime: The prohibition of commercial advertising which could reach market participants outside the scope of eligible investors would be consistent with the rationale and functioning of the private placement regime.

3) Mechanisms to clarify which issuers, promoters or products could place products under such private placement regime. In this regard, the Expert Group considers that it should be sufficient that the manager or the management company is domiciled in one of the EU Member States.

Box: relevant provisions of EU financial services law:

In thinking about a common approach to 'private placement', it is not necessary to start from scratch. The Expert Group notes that EU financial legislation already encompasses some of the concepts and building blocks that would be needed to construct a private placement regime, with some adjustment in

relation to appropriate experience/dealing frequency for Private Equity.

Markets in Financial Instruments Directive: The MiFID Directive contains a definition of "eligible investors" which provides that investment firms may be able to conclude transactions with designated "eligible counterparties" without having to comply with conduct of business rules and other investor protection measures. MiFID also provides a lighter-touch conduct of business regime for transactions concluded with "professional investors" – but where duties of care would still be binding on the financial intermediary.

Prospectus Directive: For cross border offer of transferable securities an EU regime exists for public offer through the Prospectus Directive. The Prospectus Directive (which applies to securities issued by closed-end funds) defines 'offer of securities to the public' and 'qualified investors'. Private equity funds can gain exemption from the Prospectus Directive for closed end funds. The exemption, by itself, does not constitute a Private Placement regime; however the exemption frees private equity funds from the obligation to publish a Prospectus when the offer is restricted to qualified investors, offers limited to less than 100 persons per Member State, and for offers where the minimum consideration is €50,000.

These elements could provide a starting-point for defining the investors with whom private equity managers could do business under a private placement regime. They are also pertinent in terms of switching off some local regulatory provisions that a private placement seeks to avoid – namely disclosure rules, conduct of business requirements. However, the different provisions and definitions are not aligned. They need to be shaped into a coherent, comprehensive and consistently implemented private placement regime.

A legislative harmonisation route seems to involve a number of pitfalls in terms of time-lags, uncertainty and the inherent difficulties of legislating to create a safe harbour for products and entities which otherwise fall outside the scope of the EU harmonising rule. The Expert Group looks to the EU institutions, CESR and the Member States to take this work forward quickly. The Group underlines the importance of having a clear and common position to which all Member States subscribe and which provides

market operators with the necessary legal certainty to solicit business from qualified investors.

Recommendation

The Expert Group encourages EU institutions and Member States to consider establishing – in non-legislative form – a common understanding of the parameters of "private placement". This could involve building on, with adaptation in relation to experience/dealing frequency, useful provisions of existing Community law as regards the notion of "qualified investors" which can be approached without triggering mandatory disclosure or conduct of business rules.

CONCLUSIONS

The private equity industry is set to play a greater role in cultivating and re-energising European companies. Private equity financing can improve management and governance in companies and provide them with a spring-board for sustained success. Private equity is a value creator. As an investment partner, it is fully committed to ensuring the long-term viability of the companies in which it invests.

Private equity can also provide desirable investment returns to naturally long term investing institutions and thereby contribute to enhancing portfolio returns required for long term savings and old age provisioning.

The European private equity industry has a bright future. Europe can be a home to a successful and growing private equity industry. Many of the conditions needed to sustain the recent growth of the industry are falling into place. However, the situation is patchy. There are Member States which have understood the importance of a dynamic private equity industry. They have put in place the necessary enabling framework. Other jurisdictions need to learn from – and improve on – these 'best practices'.

At European level, policy-makers need to be more cognisant of the specific characteristics of the private equity industry. This is not a case of special pleading. It is a case of policy-makers taking the time and care to ensure that cross-cutting financial and company law do not generate unintended consequences for the unique business models that underpin Europe's nascent private equity industry.

There is also a need for European level action to ensure that national regulatory and tax regimes mesh together. As the industry matures, managers and investors will expand their investment horizons. The frequency and size of trans-national investments will grow. However, these cross-border investments and fund-raising will be conducted against the backdrop of fragmented tax and legal frameworks. There is a need for better articulation of the national frameworks. In particular, there is a need to find sensible ways to ensure that private equity fund managers and investors are not penalised when funds invest cross-border. There is also a need to strip away some of the legal complexity that creates complications for managers/advisers when making representations to qualified investors in other Member States.

This is not a call for legislative action to align national practices. The private equity industry has shown that it is a responsible participant in the financial system. It remains clearly focussed on the needs of its essentially professional investor base. The current mix of self-regulation and nationally-based operating conditions remains appropriate. There is no need to superimpose European harmonising measures on the industry. All that is needed is for national authorities to recognise that partner country private equity managers and arrangers operating in their territory are already subject to tax and regulatory regimes in their home country. On this basis, we should look to free the industry from punitive double taxation and legal uncertainty that currently hold back the onshore activities— to the advantage of offshore structures. It has proved possible to put these conditions in place for other segments of the financial services industry.

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Report of the Alternative Investment Expert Group

Managing, Servicing and Marketing Hedge Funds in Europe



July 2006



European Commission
Internal Market and Services DG

**REPORT OF THE ALTERNATIVE INVESTMENT EXPERT GROUP
TO THE EUROPEAN COMMISSION**

MANAGING, SERVICING AND MARKETING HEDGE FUNDS IN EUROPE

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PREFACE

In July 2005 the European Commission launched a public debate on possible ways to enhance the European framework for investment funds. While the debate focuses primarily on retail investment funds that fall within the existing legislative framework (UCITS), the Commission also notes the strong growth of the alternative investment market, consisting of inter alia, private equity funds and hedge funds.

This report represents one of the first opportunities for a group of hedge fund practitioners (the "Group") to contribute to the policy debate on the development of this fast-moving business. This report is an opportunity for the industry to explain how it sees the challenges, identify areas for possible improvement and address preconceived notions about the hedge fund business.

The Commission invited the Group to report on how it sees the future development of the hedge fund industry in the European context, and whether there are any European-level regulatory or other obstacles which hold back the efficient organisation of the business in Europe.

In autumn 2006 the Commission intends to publish an investment fund strategy paper detailing the actions it proposes to take to facilitate the efficient development of the European funds sector. There may be an opportunity in that paper to consider elements of the approaches to alternative investment funds, including, inter alia, hedge funds. This report and, notably, the reactions to it will feed into the Commission's strategy paper and future policy reflections.

The Group also hopes that the analysis and associated recommendations in this report serve to fuel a wider debate on the successful development of alternative investments in the European context. The Group's members have on average about 17 years of experience in the investing and hedge funds in Europe. The Group wishes to contribute to ongoing reflections on the development of the policy framework for a vibrant European asset management business and to draw attention to areas for potential improvement in the European operating environment for hedge funds and funds of hedge funds.

The Group has now completed its report. This report reflects the outcome of the Group's discussions during the period February – June 2006. During that period, the Group met four times to discuss an evolving draft of this report. In the limited number of instances where points of view could not be reconciled, this is made clear in the body of the report. The report does not necessarily reflect the views of the organisations to which the group members belong.

The role of Commission staff in this process was to facilitate discussions – by providing secretarial support in organising and hosting the meetings, and acting as the chronicler of group discussions. This report represents a fair presentation of the views of the Group's members. It should not be construed as reflecting the views of the Commission or of its services.

The Commission services now wish to submit the assessment and views of the Group to wider scrutiny and open debate before developing a basis for a formal position. To this end, the Commission services have organised an Open Hearing in Brussels on 19th July 2006. Stakeholders are also invited to send their comments to the following address: markt-consult-july-2006expertgroups@ec.europa.eu by 20th September, 2006. These reactions will be published on the relevant website unless confidentiality is requested.

EXECUTIVE SUMMARY

Hedge funds have been active in financial markets for almost 60 years. In recent years, their scale and global reach have moved them to centre-stage. Hedge funds and funds of hedge funds now account for about \$1.2 trillion under management worldwide.

The European Union is at the heart of this growing business. European hedge fund managers now manage \$325 billion. Their customer base is broadening: hedge funds are no longer the preserve of high net worth individuals. Pension funds, life insurance companies and other institutional investors are increasingly looking to hedge funds to deliver attractive returns and portfolio diversification. Hedge funds – and derived products – are being made available to a wider investing public. Hedge fund assets are growing in size and hedge fund techniques are entering the mainstream. Hedge funds are forcing a 're-tooling' of the entire asset management business. Traditional asset managers are borrowing hedge fund techniques to deliver tailored combinations of risk and return to a wider range of investors, so that the distinction between "traditional" asset management and alternative investment is blurring.

The hedge fund business is maturing in a way that does not give rise to any need for additional specific or targeted legislation of hedge fund participants or investment strategies at a European level. The great majority of the participants based in EU countries (be they hedge fund managers, fund of hedge funds managers, prime brokers or fund administrators) are already effectively regulated in their varying jurisdictions. This is a business that has grown up on an international basis: funds or products domiciled in one jurisdiction are managed and serviced from another, for sale to clients in a third. The existing light-touch regulatory approach has, in the view of the Group, served the industry, its investors and the wider market well. It is suggested that additional regulation, which does not and arguably cannot accommodate the need for unrestricted investment freedom or the international organisation of business models, is likely to fail and will do little to further protect investors compared with the status quo. In particular, regulation of investment strategies is the very antithesis of the hedge fund business and would be misguided.

The Group calls on European regulatory authorities to adopt a policy of enlightened self-interest. This would recognise that attempts to further regulate this evolving industry will drive the business and its investors offshore or lead to the packaging of hedge fund based investments in other forms. Therefore, efforts to create a suitable regulatory environment in Europe should work within this concept of the market.

As the industry matures and the investor base broadens, many Member States have stepped up their regulatory engagement with this business. The Group welcomes this engagement and any dialogue which encourages greater understanding of the industry. The Group appreciates that public authorities have a legitimate interest in the activities of hedge funds – particularly to the extent that certain hedge fund products are sold to the retail market. Member State authorities have been building regulatory systems that can support well-supervised fund managers and soundly administered hedge funds. However, the Group submits that any regulatory evolution should be a proportionate response to demonstrable risks and take account of the specificities of this business.

This report identifies areas where carefully judged non-legislative steps at a European level could facilitate the further development of this business in a European context. It acknowledges the need to balance the interests of investors, as noted above, particularly retail investors, with those of the industry. The regulatory patchwork in the European Union limits the most efficient organisation and distribution of the hedge fund business. It results in a competitive environment for those seeking to invest in the European asset management industry that is fundamentally at odds with the goals of the European Union with regard to the development of the single market. In particular, in the European

Union where enormous efforts have been made to encourage the free movement of capital and services, continued uncertainty regarding the conditions under which distribution can be undertaken stands in the way of this objective. It drives investors, who can contract with a hedge fund manager under the law of another jurisdiction, offshore. It prevents the development of a scalable onshore business. It results in inefficiencies in managing and administering portfolios, and in providing support services to the industry. All of this ultimately adds up to higher costs and reduced access for investors. If the European Union wishes to be home to a successful hedge fund business, it should take steps to remove these frictions.

The Group has agreed a set of targeted and practical recommendations which it believes are important for the continued successful development of the hedge fund business in Europe. These recommendations should not be viewed as a pretext for heavy regulatory involvement in this business, or in particular, for introducing product regulation. The proposed adjustments do not, in the Group's view, require extensive legislative harmonisation. These adjustments would facilitate the further successful development of the business without compromising regulatory objectives of retail investor protection or market integrity.

The recommendations all relate to two key areas:

- Freeing up access to investors in other Member States by removing unproductive, inefficient and unjustified legal or regulatory impediments; and
- Removing and not creating barriers to the free provision of services between Member States, which impedes access to “best of breed” service providers for essential support services such as fund administration, custody and prime brokerage.

Freeing up access to cross-border investors:

There is a growing demand from investors for access to hedge funds. Investors increasingly understand that there is a place for hedge fund investments in a properly diversified portfolio. This demand is no longer restricted to professional or institutional investors. It includes high net worth and in some instances retail investors seeking a wider range of investment opportunities than those offered by traditional equity investments. The hedge fund industry is well equipped to respond to this demand. Institutionalisation of the hedge fund industry is driving increased transparency, better valuations and risk management. The hedge fund industry wishes to service this changing investor base as efficiently as possible. It would like to do so from established platforms and centres of excellence which benefit from economies of scale and the development of the best management expertise. The industry will not develop efficiently if required to build a local management presence or fund administration centre in each target market. Nor is it reasonable to place the additional cost burden of such a national infrastructure on investors. As the industry develops, the restrictions on cross-border marketing and portfolio construction are proving increasingly costly in terms of foregone opportunities, legal uncertainty and compliance costs. These are increasingly hard to justify when the success of hedge funds is a matter of record. A further consideration is that well-intentioned national rules merely succeed in pushing investors to obtain hedge fund access through other means, such as acquiring hedge fund exposure through structured products, shares in closed-end funds or investing offshore.

The Group believes that it is time to move on. Recent regulatory developments within the European Union provide an opportunity for a fresh look at arrangements governing the Europe-wide distribution of hedge funds. These developments could overcome unnecessary obstacles to cross-border placement of hedge funds with qualified investors who are capable of self-directed investment.

The Group calls for a rational and dispassionate debate on the conditions under which retail access to hedge fund-based investments could be contemplated. Retail investor access to appropriately marketed hedge fund-based investments should no longer be taboo.

1: Member States should recognise the broadening investor appetite for hedge funds and related products by developing a regulatory approach that is compatible with these needs and the organisation of the hedge fund business.

The Group recommends that European authorities and supervisors allow the provision of investment services in respect of the full range of hedge funds and related products by investment firms authorised in accordance with MiFID – without imposing additional restrictions or formalities at the level of the fund, its manager or other participants in the value chain.

In particular, the Group recommends that regulators do not seek to control sales and distribution through product regulation or registration. The Group is of the view that regulators should focus, instead, on two levels of protection:

- First, the Group recommends that conditions be introduced to prevent access to hedge funds by investors for whom such investments are not suitable. A majority of Group members considered a minimum threshold of 50'000€ would satisfy this condition. A substantial minority considered that a higher threshold and/or other safeguards should apply; and
- Second, the Group recommends the enforcing of clear conduct of business requirements on the intermediaries and institutions who conclude sales contracts with end-investors. This is an appropriate and efficient means of providing the graduated level of protections required by different investor categories.

Pending full implementation of the above recommendations on the marketing and sales of hedge funds, there are a number of practical steps that European authorities and Member States can take to provide retail investors with access to hedge fund investing. In particular, the Group recognises the potential suitability of funds of hedge funds as retail products.

2: The majority of the Group recommends against reopening negotiations on the key provisions of the UCITS Directive with a view to facilitating the authorisation of a broad range of funds of hedge funds as UCITS. A minority considered that the time was right to broaden investment rules and other provisions of the UCITS directive to allow funds of hedge funds to be authorised as UCITS compliant funds.

3: The Group recognises the potential value in allowing retail investor access to hedge fund based investing by authorising UCITS to invest in derivatives on hedge fund indices. However, the majority of the Group recognises the validity of concerns regarding the reliability and functioning of hedge fund indices. The Group, with exception of one member, recommends that UCITS investment in derivatives based on such indices be deferred until concerns regarding the structure and performance of hedge fund indices are resolved.

4: Whilst concerned about the limitations associated with product regulation, the Group recommends that the European institutions and national authorities take all non-legislative steps needed to give effect to the mutual recognition of (nationally regulated) retail-oriented hedge fund products. These should be mutually recognised as suitable for sale to the investing retail public across the European market and for distribution under MiFID conditions. This should not be considered as a substitute for other reforms suggested with regards to improving the distribution regime for non-retail oriented funds.

A second subset of recommendations relates to regulatory provisions which unjustifiably limit the legitimate exercise of institutional investor appetite for hedge fund investments. A combination of arbitrary quantitative restrictions and potentially punitive capital penalties are imposed in certain Member States on insurance companies, pension funds and banks investing in hedge funds. This is contrary to a large body of research that supports hedge funds as an asset class for such investors and in spite of years of successful hedge fund investing in Europe. It is also inconsistent with the treatment of other investments such as equities which can have similar risk profiles for investors.

5: Regulators and industry bodies should remove absolute or arbitrary quantitative restrictions on hedge fund based investing which are imposed on some institutional investors. The Group advocates removal of any arbitrary and/or regulatory prohibition or restriction. The "prudent man" principle which informs the Directive on the activities and supervision of institutions for occupational retirement provision (IORP) should be more broadly applied.

6: The Group recommends that effective steps be taken to ensure a measured and appropriate implementation of the Capital Requirements Directive – one which does not result in exaggerated and prohibitive restrictions on bank investment in hedge funds. The European Commission and Committee of European Banking Supervisors should, at an early stage of the implementation of the Basle II framework, compare and reconcile the trading book rules in each Member State as well as how they are construed and applied by the competent supervisory authorities. Guidance is particularly needed in respect of the level of transparency that regulators should require when allowing banks a more favourable “look-through approach”.

In addition, the Group recommends that the European Commission provides for appropriate provisioning requirements under its forthcoming proposals for Solvency II. The forthcoming draft Directive should not impose excessively onerous reserve requirements which would represent an unjustified deterrent to investment in hedge funds by life-insurers.

7: The Group urges the European Union and national authorities to enter into negotiations with the US Securities & Exchange Commission and other relevant parties with a view to securing exemption from the US registration requirements for European hedge fund managers who are already registered with a Member State authority and are doing business with US qualified investors. If new regulations are put in place due to the US Court of Appeals decision, the Group urges the European Union Commission to make appropriate comments and to enter into negotiations so that the final regulations that are put in place do not have adverse consequences for the European Hedge Fund industry and to specifically ensure that no dual registration is required for managers already regulated in Member States.

Creating a single market for hedge fund support services:

Due to reliance on regulatory concepts borrowed from the retail environment, nationally regulated hedge funds are currently not always able to choose service or liquidity providers from across Europe. Some providers have to comply with rules on liability of sub-custody networks or re-hypothecation which are often not appropriate to the risk/reward balance which exists in the hedge fund industry between funds and service providers. In addition to restricting the free movement of services between Member States, these rules can have the effect of reducing access to the best levels of service provision and efficiency in back and middle-office operations.

8: An absolute requirement for a local entity to perform custody functions for European hedge funds does not significantly increase the level of investor protection available above that required by such sophisticated hedge fund investors; in reality it restricts the ability of managers to generate returns which in turn impedes the ability of the European hedge fund industry to grow and

compete in the global market place. Such requirements also prevent the provision of cross border services by custodians in other Member States and stifle competition.

Member State regulators should not impose a requirement for the appointment of a domestic custodian upon European hedge funds. The Group recommends that the provider of custody services to a European hedge fund should be a regulated provider of custody services, either domestically or in another Member State, and that this should be coupled with a minimum assets requirement.

9: Custodians and prime brokers are established in highly regulated European jurisdictions and are subject to detailed rules governing the provision of custody services. The Group supports a requirement that custodians, whether appointed solely as custodians or as part of a prime brokerage mandate, should be obliged to act reasonably and take due care and skill in monitoring the sub-custodian.

In addition to the requirement that a custodian be regulated in a Member State, the Group would support the use of a minimum assets test by Member States. This would mean that a regulated firm that is appointed as a custodian to a European hedge fund would be subject to a minimum assets test and/or a requirement that the custodian or its ultimate parent hold a specified credit rating.

The Group recommends that Member State regulators and the Commission should seek to reduce regulatory discrepancies in this respect, especially in light of the intended harmonising effect of MiFID, with particular regard to the sections dealing with custody of client assets and the prohibitions against "gold-plating" the Level II provisions in domestic implementing legislation.

10: Re-hypothecation limits are a critical economic variable contributing to the cost and price of providing the prime brokerage service. Prime brokers are established in highly regulated Member States and are subject to detailed rules governing the provision of regulated services.

The Group recommends that neither Member States nor the Commission impose any regulatory restrictions upon re-hypothecation limits for European hedge funds and that such matters be regarded as commercial terms of business to be negotiated between the fund and the prime broker. Any right of re-hypothecation should, however, be transparent to investors through the medium of disclosure in the fund offering documents. The Group would support any requirement, either at Member State or Community level, that a right of re-hypothecation be coupled with an enforceable set-off clause in the brokerage documentation.

However, if a ceiling is considered necessary and supervisors insist on imposing some limit for investor protection reasons through further banking/prudential rules, then it is appropriate:

- to measure that limit by reference to the level of indebtedness rather than by reference to the NAV of the fund. A prime broker can determine on any day how much the fund owes it but it cannot easily track the NAV because calculating this requires more information than is available to each prime broker, especially as most large funds now have more than one prime broker;
- to couple limitation on re-hypothecation with close-out netting provisions which would enable the setting off of the prime broker's redelivery obligation against the fund's liabilities to the prime broker; and

- to ensure that each Member State recognises that a prime broker regulated in another Member State is entitled to provide prime brokerage services (for example, custody, clearing, stock and cash lending, and research) to hedge funds regulated within its territory.

11: As regards asset valuation, considering the global nature of hedge fund operation and the active participation of most Member State regulators in the IOSCO Standing Committee n° 5, the Group does not wish to pre-empt the IOSCO report and make specific recommendations at this time. Nevertheless, the Group is hopeful that IOSCO will not recommend the need for direct regulation or legislation in respect of hedge fund valuation and that it will advocate a system of best practice that relies upon industry led codes of conduct and permits different levels of independence in relation to the valuation function coupled with transparency for investors through full disclosure, thus allowing hedge fund investors to take the level of independence of the valuation function as well as the methodology into account as part of the due-diligence prior to investing.

A [list](#) of the Group's eleven full recommendations is set out in the annex to the main report.

MAIN REPORT

1. Setting the record straight

Hedge funds can be best described by reference to common investment characteristics and practices. Hedge funds encompass a wide range of different investment objectives, strategies, styles, techniques and assets, offering a wide spectrum of risk/return profiles. The main characteristic of hedge funds is that they are more flexible in terms of investment options or strategies than traditional collective investments.

There is no comprehensive, uniform and universally accepted definition of a hedge fund or a hedge fund manager. European Member State rules regarding hedge funds do not employ formal, legal or specific definitions. This lack of legal precision has not stopped a lively and sustained policy discourse on hedge funds in recent years. The hedge fund industry appreciates the need for the heightened regulatory engagement that accompanies its rapid growth and deepening presence in global financial markets. This report represents an opportunity for some industry participants to communicate a business perspective on the key challenges standing in the way of successful growth of this business in Europe.

The lack of legal definition might lead to some misconceptions or misunderstandings in the policy making community. However, none of the recommendations that are made in this report requires any legal definition of hedge funds to be implemented.

1.1. The role of hedge funds in the financial system

The main driver of the success of hedge fund investing is the recognition of the usefulness of these strategies in terms of enhancing risk-adjusted portfolio performance.

Portfolio diversification: Inclusion of hedge funds in a balanced portfolio can reduce overall portfolio risk and volatility and increase returns - benefits derived from the low correlations between hedge funds and traditional assets.

ECB¹ compared data from 1994 to 2004: all correlation coefficients between hedge fund family indices² and major stock market indices were small and even negative in some cases. The case for the inclusion of hedge funds in an investor's portfolio becomes even more compelling when historical risk-adjusted returns are taken into account. With the exception of certain directional strategies, other hedge fund strategies seem to outperform stock and bond markets on a risk-adjusted basis.

Positive and uncorrelated returns:

Notwithstanding some reservations with respect to the accuracy of hedge fund indices, it has been argued³ that hedge funds investment styles – many uncorrelated with each other – can produce attractive returns in both rising and falling equity and bond markets with lower overall market risk than long only investment funds. Hedge funds therefore offer longer term investment solutions, reducing the impact of traditional market cycles and the pressure to correctly time market purchases and sales.

Less volatile returns: Hedge funds target a wide range of volatility targets. However many hedge funds experience lower volatility than equity (long-only) UCITS⁴ funds investing in growth stocks, technology stocks, or emerging markets. Hedge funds have also shown that they can provide capital preservation in sustained recent bear markets and many structured products also provide capital protection which removes capital risk.

The benefits of hedge funds are not confined to the level of individual portfolios. They have equal impact throughout the financial system.

Overall, by using a full range of financial instruments and by acting as the counterparty in many different markets, hedge funds play a key

¹ ECB Occasional papers, "[Hedge funds and their implications for financial stability](#)", August 2005

² CSFB/Tremont database

³ Cf. the above mentioned ECB paper.

⁴ Undertakings for collective investment in transferable securities (UCITS) under Council Directive of 20 December 1985 ([85/611/EEC](#))

role in the reallocation of risks among market participants. Market developments in recent years have placed the risks of financing real economic activity in the hands of investors whose aversion to risk varies widely. Hedge fund varied strategies respond to different investors' risk profiles. Furthermore, hedge funds finance directly the companies by participating in capital-raising and thus, reduce the funding rates of innovative and/or risky projects.

Hedge funds improve the functioning of financial markets. They provide markets with liquidity and have a significant stabilizing influence by spreading risks across a broad range of investors. Indeed, hedge funds often take alternative market views (contrarian trading strategies), can leverage their positions and generally change their portfolio composition much more frequently than traditional funds. Hedge funds also tend to be active in newer developing markets, often creating sufficient liquidity to allow mainstream managers to follow (e.g. credit derivative markets, over-the-counter markets and syndicated bank loans). Hedge funds increase market efficiency through the arbitrage of price differences between similar securities across markets or (cf. IMF⁵) by providing price discovery (e.g. on credit derivative markets).

Through their ability to engage in short-selling and to take contrarian approaches, hedge funds may also act as a counterbalance to market herding. Concerns have been expressed that hedge funds can magnify "herding" and, so, contribute to asset bubbles in some markets. However, herding behaviour has not been proven to be inherent to hedge funds.

Hedge funds importantly contribute to (and actively benefit from) financial innovation. The impact of hedge funds on traditional funds has been compared⁶ to that of cell phones on land lines and low budget airlines on flag carriers. Hedge funds are catalysts for change in the traditional fund universe and have prompted a

major rethink of the ground-rules for asset management. Some mainstream investment managers have adopted long short or derivatives-based strategies. Others have chosen to provide absolute returns via other routes. Consequently, the borderline between hedge funds and mainstream investment funds is starting to blur.

An example relating to the back-office functions illustrates the innovation which is driven by hedge funds. Whilst automation and outsourcing of back-office functions are seen as a route to lowering costs and speeding up execution, hedge funds generally require skilled back-office operations, staff and systems, reflecting the greater complexities associated with many of the trading strategies employed and underlying investments held. These complexities result in a higher barrier to entry and require greater investment costs, both in terms of technology and skilled personnel. In this context, the hedge fund industry delegates certain back-office operations to a growing industry of service providers: administrators, prime brokers, custodians and others. The expertise offered by these experienced professional service providers often results in a higher degree of efficiency and professionalism within the operational functions.

1.2. Demystification – challenging the myths

In 2005, 39,989 press articles⁷ mentioned "hedge funds", 43% above the previous 2004 record and more than 100 articles a day. Nevertheless, there are so many misconceptions and so much erroneous reporting about hedge funds that the Group believes that the record deserves to be set straight.

1.2.1. Hedge funds are not prone to fraud or market abuse

Recent research in the US⁸ indicates it is not possible to conclude that hedge fund managers engage in fraudulent activities disproportionately or more frequently than managers of regulated funds. The Group would

⁵ Global Financial Stability Review; April 2006.

⁶ "[Hedge funds: a catalyst reshaping global investment](#)" KPMG-Create

⁷ "100 times a day: Hedge funds and the media"; Waleck et Associates, March 2006

⁸ Greupner, Erik J.: Hedge funds are headed down-market: a call for increased regulation? San Diego (2003)

further argue that the lack of instances of hedge fund fraud in Europe is attributable (at least in part) to the regulation of the hedge fund managers and the common European practice of using independent fund administrators. In addition, most reported frauds involve the use of hedge fund vehicles as a method of extracting money from their victims. As such, these instances relate more to the activities of the individuals concerned and are not intrinsic to hedge funds.

Hedge funds operating in European markets are subject to the Market Abuse Directive as are all other users of those markets. Additionally, the hedge fund industry, as well as other market participants, is working with regulators to establish where the boundaries lie so that the industry continues to act well within the law.

1.2.2. Hedge funds are no longer the preserve of super-rich and risk oriented investors

In the 1990s most hedge fund investments came from high net worth individuals. Although they increased their allocation to hedge funds, their share of the total declined to 44% in 2005 from 62%⁹ in 1996 due to the rise in institutional capital. Indeed, recent years have been characterised by increased investment from institutional investors, which accounted for 26% of the assets invested in single hedge funds in 2005. Fund of funds also represented 30% of the share, with \$395 billion under management at the end of 2005. Consequently, professional investors amounted to 56% of all investors at the end of 2005. In terms of inflows, research¹⁰ projects that pension funds and other institutions will account for 52% of inflows into hedge funds in 2006 and 2007 and 53% in 2008. This compares with a 28% share of inflows in 2004.

1.2.3. Hedge funds are not a significant threat to financial stability

There is little evidence to suggest that hedge funds threaten financial stability. Some concerns have been expressed, for instance about the growing impact of hedge funds on the revenues of investment banks (revenue dependence).

However, the difficulties triggered by the failure of the world's largest hedge fund (LTCM) in 1998 have prompted the tightening up of controls as investment banks have significantly improved the way in which they manage their exposures to hedge funds (greater selectivity, more collateralisation etc). Several public and private initiatives¹¹ have been launched to improve the risk management practices of the counterparties to hedge funds, and these have led to sounder practices. They specifically address areas such as banks' policies and procedures when dealing with institutions employing leverage, information gathering and credit analysis, exposure measures and the monitoring of such exposures, credit limits, and the link between credit enhancement tools (e.g. financial collateral or additional termination events) and the specific characteristics of such high-leverage institutions.

1.3. A challenge to established corporate governance models?

Concerns have been expressed that hedge funds are increasingly investing in companies and pushing for changes in the management or the strategy of those companies by imposing short-term views. In reality, the size of the hedge fund business, as well as the positive role it plays in company financing and financial markets, makes hedge funds more visible. They have become more active investors in corporate equity and active shareholders of the companies in which they invest. Many would argue that they are in fact the modern proponents of the shareholder-based model of corporate governance.

There is some pressure for institutional investors at least to be subject to greater transparency and to be obliged to disclose their voting policies (possible legislation is being discussed in a few Member States). However, there is no justification in principle for distinguishing between different types of institutional investors. Finally, hedge fund activities are monitored by regulators which are entitled to ensure that these participants respect relevant

⁹ Source: [Hennessee Group LLC](#) and [IFSL](#)

¹⁰ McKinsey Asset Management

¹¹ See the Counterparty Risk Management Policy Group II "[Toward greater financial stability, a private sector perspective](#)"; 27th July 2005 (so-called Corrigan II report)

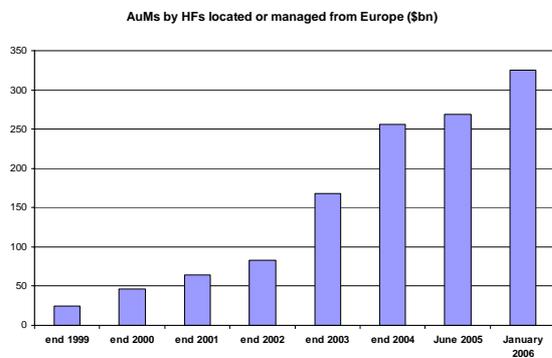
existing regulations, such as vetting the proper use of securities' lending possibilities, respecting rules on insider information and the rights of minority shareholders.

2. The European hedge fund market

2.1. The Success of the European industry

Assets under management of the global hedge fund industry totalled \$1.2 trillion¹² at the first quarter of 2006 – an increase of 13% on the previous year. The number of hedge funds increased 6% in 2005 to reach around 9,000. At the end of 2004, assets managed by hedge funds represented 2.17% of the global assets managed by insurance, pension or investment funds (against 0.70% at the end of 1998).

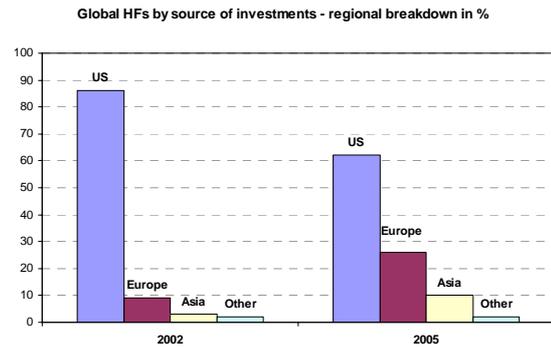
The European market has been at the forefront of this growth¹³. Hedge funds corresponding to the working definition and located in or managed from the European Union numbered around 1,250 in January 2006. They have assets of more than US\$ 325 billion. Interestingly, the European market share is growing as shown in the following charts¹⁴:



¹² This figure is estimated from various industry databases, as notably [Hedge Fund Research, Inc](#) at the first quarter of 2006. It might include bias or double-counting.

¹³ In the following, the term “European Union hedge funds” refers to hedge funds incorporated or organised in the European Union and/or with managers incorporated or domiciled in the European Union. This includes hedge funds that are managed outside the European Union but are domiciled within the European Union and vice versa.

¹⁴ Source: IFSL estimates based on EuroHedge and Hennessee



The average size of a European Union hedge fund is \$258 million with variation around this average: in the United Kingdom, \$325 million, in France \$182 million, etc. It seems to be increasing.

The optimal location and form of each entity within the hedge fund business is frequently determined according to factors such as access to skilled professionals and potential investors, tax efficiency, proximity to major markets and having an appropriate regulatory regime. The European Union hedge fund business is consequently organised as follows:

Location of hedge fund managers: Most, if not all, hedge fund managers located within the territory of European Union Member States are subject to a supervision and authorisation regime. London is the second centre of management after New York at a global level. London is Europe’s leading centre for the management of hedge funds. In January 2006, 78.5%¹⁵ (\$256 billion) of European hedge fund investments were managed out of the United Kingdom (or nearly two thirds of the number of European hedge funds). It is estimated that around 20% of global hedge fund assets are managed by United Kingdom hedge fund management groups which are fully regulated by the FSA.

Domicile of European Union hedge funds: Most hedge funds or products are companies, partnerships or trusts (or similar vehicles) domiciled in offshore jurisdictions which do not impose taxation on the vehicle, thus making the investment less disadvantageous from a tax

¹⁵ Source [IFSL](#) Research and data provided by [Eurohedge](#)/Hedge Fund Intelligence

perspective for the end-investor. Offshore hedge funds are usually structured as corporations although may sometimes be structured as limited partnerships or unit trusts. At the end of 2004, 55% of the total number of global hedge funds - managing 64% of total hedge fund assets - were registered offshore versus 34% in the US; and 9% in the European Union. The most popular offshore location is the Cayman Islands (60% of European hedge fund assets) followed by the British Virgin Islands (15%) and Bermuda (15%).

Location of service providers: London is Europe's leading centre for prime brokerage and accounts for more than 90% of Europe's prime brokerage activity, as the largest investment banks are either headquartered or have a major office there. As regards hedge fund administration, Ireland and Luxembourg clearly dominate as administration centres in the European Union. Ireland-domiciled¹⁶ administrators service over 3,000 hedge funds, representing more than US\$474 billion of assets as at 30 June 2005. This covers about 50% of assets under management by European Union-hedge funds as described above. In Luxembourg¹⁷, 59 fund administrators serviced €102 billion of hedge funds assets, at the end of 2005. However, new centres of fund administration are developing. All the offshore hedge fund jurisdictions allow those funds that prefer to maintain their records in a jurisdiction separate from their domicile to do so. Consequently, a significant number of hedge funds domiciled outside the European Union are administered in the European Union principally because of the access to skilled administrators and the relative ease of communication between manager and administrator. For instance, 62% of hedge funds administered from Ireland are funds registered in the Cayman Islands.

2.2. *Moving towards institutionalisation*

In Europe, 51% of institutional investors have already gained exposure to hedge funds,

representing (on average) 7% of their assets. Pension funds in particular show an increasing level of interest in hedge funds. With funds of hedge funds as intermediaries, they have become more important as sources of capital in recent years, particularly for the larger and more established hedge funds. According to research¹⁸, in 2005 12% of United Kingdom pension funds allocated on average 6.9% of their portfolios to hedge funds. In Continental Europe and Ireland, allocations are generally higher, with 13% of pension funds on average investing in this segment. Some market observers believe that in a couple of years pension funds could account for as much as half of all hedge fund inflows. A survey¹⁹ of European pension funds shows that some pension funds rebalanced their asset allocation towards a higher proportion of equities and, above all, alternative assets such as property, commodities and hedge funds over the year 2005.

Funds of hedge funds saw net new money grow by 40% a year between 2002 and 2004, representing half of all flows into the industry. This was mainly due to first-time investors, particularly pension funds and private broker clients, looking to diversify their risks in a broad portfolio of hedge funds using disparate strategies. However, pension funds are increasingly showing interest in investing in single manager hedge funds.

Institutionalisation is having a positive influence on hedge fund processes. Today's hedge funds are increasingly monitored by professional managers at pension funds, endowments, foundations and even central banks. Institutions are typically more demanding than individual investors in requiring better investment processes and clearer reporting. For instance, they often require enhanced reporting on a frequent basis. The management of hedge fund businesses is becoming increasingly professional. The managers are monitored by the authorities of the Member State where they are located (78% in London). Institutionalisation is also enhancing the quality of hedge fund

¹⁶ Dublin Fund Industry Association, Newsletter April 2006, Alternative Investment Funds.

¹⁷ Association of the Luxembourg Fund Industry, statistical release, 7 March 2006

¹⁸ JP Morgan Fleming Asset Management, 2005 and Mercer Investment Consulting "[European institutional market place overview 2006](#)", May 2006

¹⁹ Source: bfinance.co.uk

administration. It is driving a form of institutionalisation among administrators themselves. Institutional investors want a specialised quality administrator with experienced and appropriately qualified staff, independent pricing and valuation procedures, and the technology to support this enhanced role.

2.3. The tax environment for European hedge funds

The traditional hedge fund industry started in the US. Two distinct structures evolved to meet the tax needs of US investors. Limited partnerships are designed to minimise the tax liabilities of US taxable investors whilst offshore open-ended investment companies meet the needs of offshore investors and US tax exempt investors. The lack of a similarly competitive and coherent tax regime in the EU is a major factor in preventing the development of an EU wide hedge fund industry.

Whilst some Member States have tried to encourage alternative onshore structures, usually by imposing punitive taxation measures against investment in offshore funds, such measures, have met with limited success because there is insufficient demand from any one country to merit hedge fund managers setting up a plethora of onshore funds tailored to each tax regime. Instead, the hedge fund industries in those Member States are typically characterised by structures designed to circumvent the punitive tax regimes. Member States should recognise that offshore hedge funds are meeting pent up demand from investors and that investors will find a tax efficient way to invest in these vehicles regardless of local tax regimes.

The Investment Manager exemption (IME): One of the reasons for the great success of the hedge fund industry in the United Kingdom has been the clarity provided by the investment manager exemption. This essentially provides that the existence of a United Kingdom based fund manager will not bring a fund onshore for tax purposes provided that overall policy and control of the fund rests outside of the United Kingdom. The success of this approach is

evidenced by the fact that other jurisdictions with aspirations to grow their hedge fund industries, such as Hong Kong and Singapore, have recently adopted similar legislation. The US similarly abandoned the so called "10 commandments" a number of years ago in order to clarify the position of onshore managers of offshore funds.

Where a fund has a UK investment manager, there is the potential for the fund to be treated as 'permanently established' in the UK and for the fund's profits to be subject to UK tax. This will only be the case if the fund is carrying on 'trading activities' rather than operating as an investment company and would, but for the IME, generally be relevant for hedge funds. The IME exempts UK managers of non-UK resident funds from UK tax on profits.

A number of conditions need to be satisfied for the IME to apply and include, most importantly, that the manager must be operating independently and the trading income must derive from 'investment transactions' (which covers financial instruments in common usage, including most cash settled derivatives).

The IME is, however, very narrowly drafted covering only those transactions in which a fund manager is involved. As the definition of investment transaction goes back to the early 1980's it has little or no relevance in today's markets. To seek to remedy this, there are some current discussions as to whether the exemption could be broadened to include some of the newer strategies that hedge funds have developed. The Group suggests that it is not in the interests of the industry or regulators to drive hedge fund managers offshore by introducing the risk that an onshore manager will bring the fund onshore for tax purposes. The Group believes that other Member States could benefit from adopting the IME.

2.4. The regulatory environment for European hedge funds

2.4.1. No specific legislation at European Union-level

Hedge funds are generally not structured in a way that allows them to be authorised as UCITS.

In particular, hedge funds do not adopt investment policies that comply with the strict investment limits imposed on authorised funds (UCITS). Rather than structuring highly restrictive UCITS authorised funds for the retail market, hedge funds have traditionally been targeted at high net worth investors and institutions who can invest in less restrictive fund structures. As a result, hedge funds have been promoted under a legislative patchwork, which varies across Member States, in some cases allowing for the private placement of products to non-retail investors, and in other cases prohibiting all such promotion.

Although there is no direct European legislation on the funds themselves, the various service providers within the hedge fund industry are subject, to varying degrees, to numerous European Directives including the Market Abuse Directive, Capital Adequacy Directive, Money Laundering Directive and, in the future, the Capital Requirement Directive, the Prospectus Directive and the Markets in Financial Instruments Directive (MiFID).

European Union banks and credit institutions (which are among the first tier of European investors in hedge funds) are (highly) regulated by European Union legislation (capital adequacy, collateral, due diligence requirements, risk control policies, etc.). The principal regulatory line of defence for banks lending to hedge fund counterparties is the revised Capital Requirement Directive. This will take effect at the end of 2006. While there is no special treatment for hedge fund exposures in the form of lending or of equity stakes, the new Capital Requirement Directive will introduce some relevant refinements (e.g. new rules on securities lending, which will affect prime brokerage business). It will also make it clear that equity stakes in hedge funds should not be held in the bank's trading book (where they get a more favourable capital treatment) unless they meet certain transparency and liquidity requirements. These considerations are further discussed below.

2.4.2. Different national approaches to a global business

Several Member States have recently introduced national regulatory regimes²⁰ to provide an environment for the onshore management, constitution and distribution of hedge funds and funds of hedge funds. These regimes typically involve registration and oversight of hedge fund managers, as well as structural separation of the hedge fund manager and the custodian. The main rationale appears to be aimed at bringing onshore what was previously offshore and allowing restricted access of retail investors to these products. In some Member States, the freedom for asset managers to act within trading strategy limits is counter-balanced by a ban on offering to the public. In other Member States, "hedge funds" can be offered to the public, but at the price of a significant restriction of the asset manager's freedom to determine the content, policies and practices of the investment. In addition to the requirement for the hedge fund manager to be registered and to hold minimum capital, these regimes may often involve regulation at some or all of the following levels:

- **Investment restrictions/product regulation:** Some Member States have established authorisation regimes for funds. These may regulate some aspects of product performance or investment policy (such as diversification limits, use of leverage, valuation and other portfolio constraints). These regimes considerably vary from one Member State to the next. The Group is strongly of the view that product regulation is likely to create arbitrary and misplaced or out of date restrictions which negatively impact on portfolio construction and performance and are unlikely to be in the best interests of investors.
- **Fund constitution/administration:** The approach of most Member States to regulation of hedge funds borrows widely from the structural principles that have been laid down in UCITS law for traditional investment funds – namely independent controls on valuation of the funds and its positions, existence of a depository to

²⁰ See [table 1](#) in annex

perform certain risk controls etc. All Member States, following the example of the UCITS Directive, require the existence of a custodian for the fund's assets in order to ensure that investors' assets are kept separate and recognise that the fund manager can utilise the services offered by the prime broker. However, the custodian's duty of care, and therefore liability, for the actions of its sub-custody network varies across Member States.

- **Distribution to retail investors:** Member States take significantly different approaches to the public offering of hedge funds and related products in their jurisdictions. Some Member States impose a minimum subscription amount or qualitative tests relating to the target audience to whom hedge funds can be sold to limit the marketing of hedge funds to the retail public.
- **Distribution to qualified investors:** Many Member States have set up a national regime for private placement that may be used by the distributors of hedge funds, provided certain conditions are met. The basic premise of 'private placement' is that regulation should not encroach on the ability of private parties to freely enter into a contractual relationship, where the contracting parties are capable of understanding the nature of the bargain, including any attendant risks. However, private placement regimes vary in terms of who is eligible to invest and the products that can be promoted. Eligibility is sometimes conditional on the "institutional" nature of the investor, sometimes by reference to a (limited) number of subscribers, a minimum subscription or holding amount, or in terms of who is active in soliciting business. Finally, some regimes may limit the possibility of private placement to specific kinds of security (e.g. closed-end fund shares). The result is a legal minefield which hedge fund managers or promoters must attempt to negotiate before being able to distribute across Europe. The consequences of operating within the scope of the private placement regime also differ.

In some cases, the consequences may be limited to a waiver from the obligation to publish a prospectus or other mandatory disclosures. Compliance with certain promotion rules (such as marketing techniques) and mandatory product registration with the local regulatory authority may also be required.

Thus, although they present some common features, these regimes considerably vary from one Member State to another²¹. This regulatory fragmentation creates a barrier to the cross-border distribution of hedge funds and is a major impediment to the development of a European wide industry from a distribution perspective. It results in undue restrictions and acute uncertainty as regards the conditions under which distribution can be conducted. One of the major implications is that those investors, who can contract with a hedge fund manager under the law of another jurisdiction, invest offshore. In addition to preventing the creation of a scalable onshore business, it also results in inefficiencies in constructing, managing and administering portfolios, and in providing support services to the industry, thus resulting in higher costs and greater complexity. If Member States wish to provide a regulatory environment which is conducive to the successful development of a European presence in this industry, they should take enlightened steps to remove these inefficiencies.

3. Cross-border marketing and distribution of hedge funds

There is a growing demand from investors for access to the range of investment opportunities offered by the hedge fund industry. Thus, the demand for hedge fund investments in a properly diversified portfolio (which is supported by research) is no longer restricted to professional or institutional investors.

Traditionally, hedge fund based investing has been off-limits for retail investors. Regulators have been reluctant to allow small, inexperienced investors to dabble in products

²¹ "Hedge Funds Regulation in Europe"; A comparative survey; November 2005; EFAMA

that they perceived as using highly complex trading strategies. The hedge fund industry did not consider the commercial stakes sufficiently compelling to restructure its products or challenge this perception and assume all the regulatory overheads that servicing the mass market would entail. Many hedge fund boutiques are still of this opinion and wish to exclusively focus on their traditional investor base, albeit that this investor base may include funds of hedge funds whose end investors are changing.

However, the situation is changing as a result of strong demand from investors for a wider range of options. The hedge fund industry is well equipped to respond to this demand. Institutionalisation of the hedge fund industry is driving increased transparency, more sophisticated valuation techniques, and operational risk management (cf. section 2.2.). This makes it easier for many hedge fund managers to serve a broader investor base which in turn is finding that traditional investments are becoming more complex in any event (reportedly 70% of retail fund managers are making extensive use of derivatives-based leverage to deliver capital protection and absolute returns).

The hedge fund industry wishes to service this changing investor base as efficiently as possible. It would like to do so from scalable established platforms and centres of excellence. This will allow economies of scale and the best management expertise to develop. The industry cannot afford the cost or diseconomies of scale in building local management presence or fund administration in each target market. The hedge fund community is used to managing business models which span different regulatory jurisdictions. They are used to serving a sophisticated clientele dispersed across several continents.

However, as the industry develops, restrictions on cross-border marketing (where available at all) are proving increasingly costly in terms of foregone opportunities (for both managers and investors), legal uncertainty and heavy compliance costs. These costs come without any tangible benefit in terms of investor protection

or risk-adjusted portfolio performance. They are increasingly hard to justify when the success of hedge funds is a matter of record. They weigh heavily on hedge fund business and its investors. For instance, well-intentioned national measures merely succeed in pushing investors to obtain hedge fund access through other means, such as acquiring hedge fund exposure through structured products, shares in closed-end funds or investing offshore. As a result, cross-border marketing restrictions are adding to the cost of acquiring hedge funds in terms of the further level of complexity and/or a distortion in the competition between different forms of products. They do not achieve their intended goal.

The Group believes that it is time to move on from the current sub-optimal situation. Recent regulatory developments within the European Union provide an opportunity for a fresh look at arrangements governing the Europe-wide distribution of hedge funds. These developments could overcome unnecessary obstacles to cross-border placement of hedge funds with qualified investors who are capable of self-directed investment. The Group also calls for a rational and dispassionate debate on the appropriate conditions under which retail access to hedge fund-based investments could be contemplated. The Group would like to propose an approach which will provide those investors who want to access hedge fund investing with the ability to do that under secure conditions. This approach is based on two levels of protection.

3.1. Level one: eligibility restrictions to limit exposure of less qualified retail investors

In order to avoid the inappropriate exposure of less qualified retail investors to hedge fund investing, the Group considers that it would be opportune to retain some constraints or "eligibility control" on the possibility for individual investors to invest in hedge funds. In particular, a majority of Group members considered it appropriate to require a minimum consideration of 50'000€ per offer from each investor.

A substantial minority of Group members considered that this monetary threshold would not be sufficient to disqualify retail investors for whom hedge fund based investing may not be suitable. Some members belonging to this minority considered that the recommended threshold should be raised. Other members of this minority felt that alternatives to a monetary amount should be used – for example, a process-based system. Still others argued that additional conditions – such as a requirement that the manager be regulated in a Member State or an OECD country – would be appropriate.

3.2. Level two: regulation and supervision of distributor or arranger

For all investors who meet this eligibility condition, a second level of protection would be provided by the regulation and supervision of the intermediary or institution which sells or places the investment. To the extent that the intermediary is appropriately regulated and supervised and properly acquits all duties of care to the end-investor, there should be no need for further regulation at the level of the investment product (including hedge funds), the issuer/fund manager (the Group notes that 95% of European hedge fund assets are managed by managers domiciled in Europe) or other actors in the chain.

A shift to a greater focus on supervision of intermediaries is already implied by the Prospectus Directive in respect of complex securities. However, the Group notes the inconsistency that exists in respect of the “Qualified Investor” regime created under the Prospectus Directive when looked at in the context of cross border sales of hedge funds. It is hard to defend a regime that allows the sale of individual equity and debt securities to certain classes of person without any regulatory intervention as to the “product” whatsoever and yet does not allow similar flexibility for hedge funds which may well have lower volatility, lower leverage and a more diversified portfolio of risk than a single company stock. This position supports the minimum investment suggestion put forward by the majority of the Group. The spirit of the Qualified Investor regime, possibly extended in specific

circumstances to retail investors, can be achieved through the MiFID regime.

Thus, the Group considers that where the institution or participant which concludes a contract with the end-investor is authorised or regulated in accordance with MiFID provisions, there is no need for further regulatory oversight of the product or the manager. This approach would be neutral in respect of the fund domicile, legal structure, its investment policy or strategy and its administration and prime brokerage arrangements. Hedge funds and related products, irrespective of domicile of the fund, the manager, custodian or fund administrator, could be sold under MiFID regulation cross border without triggering additional local requirements in terms of disclosures, product registration or investor protection.

The MiFID Directive, the implementation of which is not yet finalised and which is scheduled to be transposed into the national law of Member States in November 2007, establishes a set of effective disciplines for controlling behaviour of distributors. This would pave the way for a consistent approach across Europe regarding the distribution and sales of hedge funds and related products to different categories of investors.

It would clearly fall to the distributor to take account of the specific situation and sophistication of different investors notably by implementing the graduated levels of conduct of business protection that are foreseen in the MiFID Directive. This Directive – the detailed implementation of which is still being worked out – provides extensive harmonisation and prescription in terms of the types of protection that should be offered to different categories of investors. In particular, it would imply that:

- Financial institutions (when they do not explicitly request to be treated as professional investors) and other eligible counterparties would not be owed any conduct of business duties;
- Professional investors (as defined in the MiFID annex) would receive a light-touch version of the conduct of business protections; and

- Retail investors would be owed the full set of conduct of business obligations. This would encompass risk warnings, relevant disclosures, and suitability and appropriateness tests.

Recommendation # 1: Member States should recognise the broadening investor appetite for hedge funds and related products by developing a regulatory approach that is compatible with these needs and the organisation of the hedge fund business.

The Group recommends that European authorities and supervisors allow the provision of investment services in respect of the full range of hedge funds and related products by investment firms authorised in accordance with MiFID – without imposing additional restrictions or formalities at the level of the fund, its manager or other participants in the value chain.

In particular, the Group recommends that regulators do not seek to control sales and distribution through product regulation or registration. The Group is of the view that regulators should focus, instead, on two levels of protection:

- First, the Group recommends that conditions be introduced to prevent access to hedge funds by investors for whom such investments are not suitable. A majority of Group members considered a minimum threshold of 50'000€ would satisfy this condition. A substantial minority considered that a higher threshold and/or other safeguards should apply;
- Second, the Group recommends the enforcing of clear conduct of business requirements on the intermediaries and institutions who conclude sales contracts with end-investors. This is an appropriate and efficient means of providing the graduated level of protections required by different investor categories.

3.3. Cross-border retailing of suitable hedge fund products:

Pending the implementation of MiFID rules along the above lines, and a shift to intermediary focused regulation, there are additional steps that European authorities can take to respond to the changing profile of hedge fund investors. These pragmatic steps build on existing national initiatives which are already being taken to facilitate broader investor access to hedge fund-based investing.

Box: Current channels for bringing hedge based investing to the European retail investor

A gradual broadening of the hedge fund investor base to retail investors is already underway. This trend should not be overstated. The breakdown of assets under management by source of capital does not show significant direct inflows from retail customers. However, retail clients are gaining increased access to hedge fund-based investments through the following routes:

Listed closed-end hedge funds: some hedge funds have a European stock exchange listing. Most listed funds (when they have appointed a market maker) present investors with the benefit of improved liquidity whilst offering the product provider with access to a new audience of investors and a stable pool of capital to manage. Historically, closed-end funds may have traded at a significant discount to their net asset values and some products have not been considered as a success. Since the adoption of approaches to narrow the discount to net asset value, this is no longer the case in London where most funds launched in the last 12 months trade at a premium, not a discount. The demand for hedge funds within this type of structure is increasing. Listed shares can be sold across the European Union upon launch on the basis of a simple prospectus and traded on an exchange or OTC. Listed funds have to comply with transparency and reporting requirements. Their transactions and intermediation providers are fully regulated by the MiFID.

Structured notes based on underlying hedge funds are successful in terms of market size. It is estimated that of the \$1.2 trillion²² of assets under management, approximately \$100-150 billion is

²² Source: [Hedge Fund Research, Inc.](#), at the first quarter of 2006

invested via structured products. These products are estimated to account for 20-25% of net capital inflows to hedge funds at global level. They are still seen as the 'vehicle of choice' among many participants within the hedge fund industry for a variety of reasons, including economic flexibility (such as capital protection combined with attractive risk adjusted returns) and tax benefits particularly in those markets where there are punitive tax regimes to discourage direct investment in hedge funds. It is worth noting that, to a certain extent in the current regime, structured notes may also be sold on a cross-border basis under the Prospectus Directive. With regard to investor protection, the investor base of structured products includes 56%²³ retail (mass market or mass affluent) investors in Europe. The distribution of such products takes place through regulated channels (retail banks, financial advisors, fund distributors) most of which will be fully covered under MiFID.

Although some members believe that a level playing field between all kinds of product structure is desirable, the Group considers that the current channels for marketing the securities of listed closed-end funds and structured notes do not require additional regulation. In both cases, necessary checks and balances are in place at the level of issue and issuer, and at the level of the distribution networks where the relevant private banking or banking networks owe fiduciary obligations to their clients. Recent moves to facilitate a more open, disclosure based approach, specifically by the United Kingdom Listing Authority is encouraged.

The Group believes that regulators should now move to recognise this reality by allowing direct retail access to suitable forms of hedge fund investment. The Group looked at two alternative routes.

First, many traditional fund managers are developing their product range to include absolute return and "alpha" strategies. UCITS III has been a catalyst for these developments by extensively broadening the scope of eligible assets for UCITS to include the use of on-exchange and OTC financial derivatives. It has also allowed extensive index-tracking strategies and the use of derivatives for return-enhancing

purposes. As a result of these changes, a new generation of **UCITS III funds potentially give retail investors access to some of the absolute return performance characteristics of hedge funds**, albeit it remains to be seen how such funds will perform. However, it is premature to talk about the convergence of retail investment fund strategies and hedge funds. It is the Group's assessment that it will remain difficult to shoe-horn any more than a handful of hedge fund strategies or funds of hedge funds into the UCITS framework. This will remain the case – even after confirmation that UCITS will be able to invest in shares of listed closed-end funds as long as they meet strict conditions. UCITS investment in open-ended hedge funds will also remain difficult – largely closing the door on bringing funds of hedge funds to market under a UCITS authorisation. Moreover, the structural conditions on valuation, redeemability and portfolio liquidity (which may often be at the price of lower returns) have proven to be too restrictive for all but a few hedge funds to date.

The Group gave some consideration to possible adjustments to the relevant provisions of the UCITS Directive to allow a broader population of funds of hedge funds to be authorised and marketed across Europe as UCITS. Some Group members also cautioned against the dangers of over-stretching the UCITS label. The Group concluded that this would amount to a major undertaking. Several of the core features of the UCITS Directive would need to be extensively reshaped. Given the scale of the challenge, and the uncertainty about the magnitude of the benefits compared to other proposed routes for opening up retail market access, the Group decided to advise against such a course of action.

A small minority argued that the UCITS Directive should be modified to accommodate funds of hedge funds by adding hedge funds to the list of eligible assets. The eligibility of hedge funds could depend on compliance with a certain number of minimum requirements and a certain degree of diversification.

The second much-touted route to providing retail investors with access to hedge fund-based investing is allowing UCITS to invest in

²³ Source: Datamonitor

derivatives on hedge fund indices. This could represent a promising route for the future. However, the Group believes that such products are less obviously suited to retail investors than funds of hedge funds. They do not present the same level of diversification. There are also open questions regarding the reliability and robustness of hedge fund indices and the valuation of derivatives based upon them. The Group encourages the industry to work constructively with CESR and the European Commission to examine these concerns and to identify the appropriate conditions under which UCITS could be permitted to invest in derivatives on hedge fund indices. One Group member argued that derivatives on hedge fund indices should be recognised by European legislation on the grounds that hedge fund indices can contribute to a better benchmarking of this business.

Additionally, the Group notes that, whilst some Member States have created certain locally supervised products, they do not extend similar marketing possibilities to comparable products authorised under other Member States' rules.

In particular, several Member States have authorised the sale of funds of hedge funds to retail investors on the grounds that they provide diversified exposure to this asset class. This has been the case, for instance, in France, Germany, Ireland, Luxembourg and Spain. Whilst there are concerns regarding the level of product regulation that some of these regimes introduced, the Group welcomes this approach and believes funds of hedge funds (or well diversified hedge funds) could provide significant benefits to a wide range of investors for whom the case may be that investment in offshore or traditional hedge funds is not appropriate.

Mutual recognition of nationally authorised hedge funds would be a logical extension of single market principles to products which are explicitly designed and authorised with the retail investor in mind and would dovetail with the full implementation of MiFID. It would recognise, moreover, that retail investors already enjoy indirect access to hedge fund investing through structured products and

securities issued by listed closed-end hedge funds. Certain Member States already implement such a practice²⁴ whereby they allow the marketing to their retail investing public. Group members believe that the hedge fund industry could be allowed to use these national concepts to build a retail investor base across the single market. Building on the mutual recognition principle would allow the cross-border marketing of such products without the need for the painstaking and unproductive harmonisation of product features.

Whilst concerns were noted about the risk of product regulation, which is evident in some national Member State hedge fund regimes to date, the Group was in favour of progressing towards **mutual recognition of hedge fund products which have been authorised for sale to retail investors under different national regimes**. Provided that the distributor is regulated under MiFID and acquits all his duties of care, these products could then be sold to retail investors on a cross-border basis. Recognition should be extended to the organisation of the participants to the value chain as they are registered with Member State authorities. However, the Group is of the view that mutual recognition must not be viewed as a substitute for the other reforms proposed, for example, making the existing regimes for cross border sales to institutions and sophisticated investors (who are likely to require products that would not qualify for mutual recognition) less restrictive.

Recommendation # 2: The majority of the Group recommends against reopening negotiations on the key provisions of the UCITS Directive with a view to facilitating the authorisation of a broad range of funds of hedge funds as UCITS. A minority considered that the time was right to broaden investment rules and other provisions of the UCITS directive to allow funds of hedge funds to be authorised as UCITS compliant funds.

²⁴ Cf. Some Member States allow, for instance, Luxembourg Part II funds (non-harmonised funds including some hedge funds) to be marketed to their retail investing public.

Recommendation # 3: The Group recognises the potential value in allowing retail investor access to hedge fund based investing by authorising UCITS to invest in derivatives on hedge fund indices. However, the majority of the Group recognises the validity of concerns regarding the reliability and functioning of hedge fund indices. The Group, with exception of one member, recommends that UCITS investment in derivatives based on such indices be deferred until concerns regarding the structure and performance of hedge fund indices are resolved.

Recommendation # 4: Whilst concerned about the limitations associated with product regulation, the Group recommends that the European institutions and national authorities take all non-legislative steps needed to give effect to the mutual recognition of (nationally regulated) retail-oriented hedge fund products. These should be mutually recognised as suitable for sale to the investing retail public across the European market and for distribution under MiFID conditions. This should not be considered as a substitute for other reforms suggested with regards to improving the distribution regime for non-retail oriented funds.

3.4. Regulatory restrictions on the buy-side

Under-funded pension funds are seeking new asset classes or investment styles offering access to equity-like premium without all the associated risks. Because of their focus on absolute performance and risk control and because they offer non-linear return profiles, hedge funds are particularly useful in an asset/liability management context. Hedge funds and other alternative investments can therefore form an effective component in a suitably diversified portfolio. Experiences from some Member States (e.g. Netherlands) point to the benefits of sensibly managed investment in hedge funds. Despite this, there are many rules in place at a national level which restrict the possibility for some financial institutions of obtaining prudent exposure to hedge funds. Life insurance companies in particular, are often prohibited from investing in hedge funds, except for their own account, on the basis that

they have underwritten premia with retail policy-holders.

The [table 2](#) in the annex illustrates the varying treatment of investor restrictions on hedge fund investments across Member States. There is no discernible pattern to these restrictions – either across countries or sectors. This suggests that these restrictions are relatively arbitrary and not grounded in any coherent regulatory or prudential considerations. Furthermore, restrictions on direct exposure to hedge funds may often be circumvented by using legal loopholes, where the case may be. Thus, even if the aim of preventing institutions investing in hedge funds was justified these restrictions rarely achieve this goal. They simply add legal uncertainty and costs.

Recommendation # 5: Regulators and industry bodies should remove absolute or arbitrary quantitative restrictions on hedge fund based investing which are imposed on some institutional investors. The Group advocates removal of any arbitrary and/or regulatory prohibition or restriction. The "prudent man" principle which informs the Directive on the activities and supervision of institutions for occupational retirement provision (IORP²⁵) should be more broadly applied.

Capital provisioning rules for banks and insurance companies:

The appetite for banks to invest in hedge funds (the Group is not concerned with bank lending to hedge funds) is heavily influenced by the capital reserves that banks are required to hold against such positions under the Basel II rules and the (soon to enter into force) Capital Requirements Directive. This affects their appetite and raises their capital costs. Two considerations determine how much capital banks must hold against hedge fund investments.

The first issue is whether banks can assign investments in hedge funds to the trading book.

²⁵ Directive 2003/41/EC of the European Parliament and the Council on the activities and supervision of institutions for occupational retirement provision (IORPs)

This would entitle them to less onerous capital provisioning than if they were allocated to the banking book: the latter involves holding reserves of 300-1200% of exposure which is prohibitively expensive. In principle, Basel II rules and the Capital Requirement Directive allow for hedge fund exposures to be held on trading book if the units are fully transferable and eligible for daily marking to market and if they are held for trading purposes. However, the Basel Committee and most regulators in the European Union have elected not to use the discretion available to them.

Second, when allocating hedge fund shares to the banking book, banks must comply with minimum capital requirements for credit risks. In doing so, they generally have the choice between two methodologies: the standardised approach supported by external credit assessments and an alternative approach (the so-called IRB approach), which allows banks to use their internal ratings for measuring credit risk. However, for some asset classes, like equity exposure, the bank's discretion is limited. Regulators frequently impose a very restrictive approach – on the grounds that a hedge fund does not provide full transparency of its investment strategy or the assets it invests in. Consequently, banks may be required to treat the hedge fund shares they hold as equity exposure attracting the highest capital requirement. Finally, regulators require banks to take a worst case scenario approach, assuming that the hedge fund invests in the asset classes involving the highest capital requirements (e.g. in junior CDO tranches). The consequence could be an effective risk weight of 1,250%. Clearly, under such conditions, banks will drastically scale back investment in hedge funds – this outcome does not represent a true reflection of the risk of hedge fund investing for credit institutions. It leads to underinvestment in the asset class by banks and denies hedge funds the possibility of raising funds from the major actors in the financial system.

Recommendation # 6: The Group recommends that effective steps be taken to ensure a measured and appropriate implementation of the Capital Requirements Directive – one

which does not result in exaggerated and prohibitive restrictions on bank investment in hedge funds. The European Commission and Committee of European Banking Supervisors should, at an early stage of the implementation of the Basle II framework, compare and reconcile the trading book rules in each Member State as well as how they are construed and applied by the competent supervisory authorities. Guidance is particularly needed in respect of the level of transparency that regulators should require when allowing banks a more favourable “look-through approach”.

In addition, the Group recommends that the European Commission provides for appropriate provisioning requirements under its forthcoming proposals for Solvency II. The forthcoming draft Directive should not impose excessively onerous reserve requirements which would represent an unjustified deterrent to investment in hedge funds by life-insurers.

3.5. *Legal restrictions on offering European hedge funds outside of Europe*

The Group draws attention to obstacles to marketing European hedge funds outside Europe, notably in the United States. Since February 2006, European hedge fund managers which market their funds in the US must be registered with the SEC, even where sales are restricted to qualified investors. Consequently, European hedge fund managers must undergo authorisation procedures on both sides of the Atlantic before being able to serve US clients. This creates significant costs and forces managers to structure their operations to comply with two different regulatory systems. Conversely, US hedge fund managers are often not faced with local registration requirements at manager level when their products are placed with European qualified investors, although the situation differs with regards to the authorisation of the product itself. The European Commission, CESR and the relevant national authorities are urged to secure balanced treatment for European hedge fund managers doing business in the US. Many Group members were of the view that, if the European Union

moves to a more open market place as implied by the shift to an intermediary-based approach, then every effort should be made to secure reciprocal treatment of European hedge fund managers in the US.

Although at the time of writing it is too early to understand fully the implications of the very recent decision of the US Court of Appeals²⁶, this may lead to the termination of the registration requirement. The Chairman of the SEC has announced in a press release that he has *“instructed the SEC’s professional staff to promptly evaluate the Court’s decision, and to provide to the [SEC] Commission a set of alternatives...”*. The Group believes that, after such evaluation, the European Commission should make appropriate comments and enter into negotiations so that the final regulations that are put in place do not have adverse consequences for the European hedge fund industry.

Recommendation # 7: The Group urges the European Union and national authorities to enter into negotiations with the US Securities & Exchange Commission and other relevant parties with a view to securing exemption from the US registration requirements for European hedge fund managers who are already registered with a Member State authority and are doing business with US qualified investors. If new regulations are put in place due to the US Court of Appeals decision, the Group urges the European Union Commission to make appropriate comments and to enter into negotiations so that the final regulations that are put in place do not have adverse consequences for the European Hedge Fund industry and to specifically ensure that no dual registration is required for managers already regulated in Member States.

²⁶ United States Court of Appeals for the District of Columbia Circuit, [No. 04-1434](#) on Petition for Review of an Order of the Securities and Exchange Commission, Decided June 23, 2006

4. Servicing the European hedge fund industry

The success of the hedge fund industry has come about in large part because the commercial interests of all parties are broadly aligned. Successful hedge fund activity requires strong operational support services to process and settle trades globally and for the majority of hedge fund strategies, the availability of leverage at commercially viable rates together with access to a reliable source of securities available for borrowing.

However, those Member State policy makers who have sought to create a market for domestic hedge funds have recognised the need for flexibility of investment approach but have often failed to appreciate that a similar flexible approach must be taken with respect to the choice of service providers. Regulatory fragmentation as regards rules governing authorisation, access and operation of service providers performing administration, custody, clearing and settlement functions for hedge funds leads to inefficiencies and creates barriers hindering the efficient development of the hedge fund market in the European Union. Furthermore, some hedge fund service providers established in the European Union and who are active on a global basis, and indeed are market leaders within the wider hedge fund industry, are restricted or limited in their ability to provide their services to hedge funds on a cross-border basis within the European Union. This regulatory fragmentation is an obstacle to the emergence of healthy competition amongst hedge fund service providers and is likely to prevent European hedge funds from competing at a global level where they are unable to appoint "best of breed" service providers across borders in other Member States.

A number of commentators and regulators have expressed concerns in relation to the valuation of complex assets traded by some hedge funds and the fact that a lack of transparency or independence in such a complex process may disadvantage investors. In an attempt to tackle any potential conflict of interest, some authorities advocate regulation of this function or suggest that it be performed by an

independent third-party service provider. Whilst superficially attractive, a closer examination of the nature of the instruments to be valued and the expertise available in the market demonstrates that such a requirement, if applied too rigidly would be unlikely to reduce the opportunity for error or fraud, would not significantly increase investor protection, and may in fact operate as a barrier to the proper allocation of responsibility and the efficient development of the hedge fund market in the European Union. The Group is however in favour of the independent valuation of hedge fund assets and an appropriate disclosure to investors, should this not be the case.

4.1. Domestic custodian requirement

Outside of the European Union, the hedge fund industry has developed without any requirement for a domestic custodian to be appointed in addition to a prime broker. However, the overwhelming majority of Member States that have sought to establish a domestic hedge fund industry to date have created a requirement that a local custodian, established and regulated in the same jurisdiction as the hedge fund, be appointed. Some Member States have gone even further and required the domestic custodian to have absolute responsibility for the hedge fund's assets and the performance of the underlying network of sub-custodians.

National rules in this area seem to have been derived in the main from the existing UCITS regime notwithstanding the fact that such a regime has been designed around the concept of retail investor protection and traditional long only funds. Whilst no doubt a useful investor protection tool in the long only investment fund sector, such protections are not required in the hedge fund sector. Domestic custodian requirements are counter productive as they provide a false sense of security and hinder the manager's ability to generate returns.

4.1.1. Questioning the added-value of such a requirement

The requirement for a domestic custodian arises for reasons of perceived investor protection and these can be examined under two main

headings: (a) protection from the failure of the custodian to perform its basic custody duties adequately, referred to as the "safekeeping role"; and (b) protection from the failure of the investment manager to manage the fund in accordance with its investment guidelines, referred to as the "oversight role".

The rationale in respect of the **safekeeping role** is that the authorising regulator will be better able to determine the suitability and stability of the custodian to perform its duties if it is regulated by the same authority and established in the local jurisdiction. As a practical matter, hedge funds need a service provider to perform custody functions because most hedge funds invest in markets on a global basis and will own securities issued in countries other than the one in which they are organised. As a result, the hedge funds will need a local custodian or depositary to hold those securities in each of the countries in which they have invested. Seeking out, employing and subsequently monitoring these custodians itself is impractical for a hedge fund management operation in terms of time, expertise and resources. Therefore hedge funds need a "global custodian" who will seek out, employ and monitor the sub-custodians. In practice, this role is played by the prime broker who delegates the custody functions to the local sub-custodians in each jurisdiction.

Prime brokers are key participants in the hedge fund value chain. In addition to the vital clearing and settlement services that they perform, without access to the cash and securities lending liquidity that prime brokers provide, hedge funds could not function effectively. In order for hedge funds to be able to provide their services, prime brokers are required, from a practical and a legal certainty perspective to have custody of the hedge fund's assets:

- In order to settle transactions on behalf of the fund, a prime broker needs to be able to transfer assets or cash as soon as trade instructions are received from an investment manager on behalf of a fund. The practicalities of inserting a further domestic custodian into the flow of instructions between the investment manager and prime

broker significantly increases the operational and cost burden, makes effective and timely trade settlement more difficult and increases the likelihood that the settlement will fail.

- Providing a hedge fund with margin finance and access to securities lending or short sales coverage services involves the prime broker taking on a degree of credit risk to the hedge fund. Naturally, prime brokers require that they act as custodian to the hedge fund's positions in order to take an effective first priority security interest over the fund's account to cover such credit exposure.

Where Member States have established domestic custodian requirements and local funds have been launched, the practical effect of the two commercial drivers set out above has meant that in every case, custody of fund assets has been delegated in its entirety by the local custodian to the prime broker who acts as “global sub-custodian”. The local custodian does not have day to day control of the assets. The only difference between these arrangements and those more commonly seen in the global hedge fund market is that there are an additional set of fees to be paid to the custodian (which reduces investor returns) and the prime broker has to provide additional reporting to the custodian.

The majority of, if not all, prime brokers performing custody functions to hedge funds established in the European Union are themselves established in highly regulated Member State jurisdictions and as a result, are subject to close regulatory scrutiny and detailed rules governing the provision of custody services. The level of regulation applicable to prime brokers in their own Member States is a persuasive counter-argument to the requirement for a local custodian, whether it takes control of the fund property or otherwise, particularly when one considers that local custodians do not in practice have either custody or control of the hedge fund assets. It is industry practice for the identity of the prime broker and the level of responsibility that it takes for its sub-custodial network to be disclosed in hedge fund offering documents, both in the traditional offshore

space and the nascent onshore industry in Europe. Accordingly, this information is often available to investors prior to making an investment.

The traditional rationale for the **oversight role** is that a custodian will necessarily see all movements in and out of the hedge fund account and will be able to determine from this whether or not the movements instructed by the investment manager are consistent with the fund's investment guidelines and/or the manager's authority. The fitness and propriety of the investment manager is a matter for the fund's directors/promoters and authorising regulator at the time that the fund is launched, together with the regulator in the jurisdiction from which the manager operates if different from that of the fund. In this regard, it is worth noting that the majority of hedge fund managers operating in the European Union are located in Member State jurisdictions where they are therefore subject to detailed local regulation of their activities. For example, 78% of such managers are located in the United Kingdom and are regulated by the Financial Services Authority.

In addition, it is also worth noting that traditional providers of custodial or deposit bank functions may not be in a position to understand and monitor complex hedge fund strategies and where exposure is taken via OTC derivative transactions, such activity may not be directly visible to the custodian in any event.

Given the level of regulation under which most established investment managers operate within the European Union, the benefits of additional oversight by a local custodian or prime broker are questionable when weighed against the additional costs. In addition, sophisticated investors of the type which invest in hedge funds often place greater reliance on due diligence that they undertake themselves rather than on a third-party service provider such as a custodian.

Recommendation # 8: An absolute requirement for a local entity to perform custody functions for European hedge funds does not significantly increase the level of investor

protection available above that required by such sophisticated hedge fund investors; in reality it restricts the ability of managers to generate returns which in turn impedes the ability of the European hedge fund industry to grow and compete in the global market place. Such requirements also prevent the provision of cross border services by custodians in other Member States and stifle competition.

Member State regulators should not impose a requirement for the appointment of a domestic custodian upon European hedge funds. The Group recommends that the provider of custody services to a European hedge fund should be a regulated provider of custody services, either domestically or in another Member State together with a minimum assets requirement.

4.1.2. The question of responsibility

The level of responsibility that a custodian has for the assets of the fund and the performance of sub-custodians differs across the globe with three main models evidenced:

- By far the most common model accounting for over 90% of hedge funds worldwide is that which exists in the main Anglo Saxon centres, the US and the United Kingdom. In this model there is no requirement for a domestic custodian and the prime broker is appointed directly. The prime broker as custodian is required to act reasonably and/or with due care and skill in selecting and monitoring the performance of any sub-custodian that it uses to hold customer assets but provided that it has acted reasonably or with due care and skill, it is not liable for the fraud or failure of any sub-custodian so selected. This level of responsibility is consistent with the standards set out for depositing client financial instruments in Article 17 of the Level II Directive of MiFID.
- In a few Member States, the domestic custodian currently bears absolute legal responsibility to redeliver assets to the fund under local law in the event of fraud or failure of a sub-custodian regardless of whether that sub-custodian was selected

with due care and skill. The domestic custodian may delegate asset safekeeping to the prime broker. However, bearing in mind that it no longer benefits from the full safekeeping fee income and has no control over the prime broker's sub-custody network but bears all the risk of that network, it is likely to want the prime broker to contractually accept and indemnify it for any sub-custodian liability. This additional level of responsibility is one that to date the majority of prime brokers have been unwilling to fully accept. The domestic custodian's position is understandable but so is that of the prime broker who cannot manage these risks and whose custody business model does not require or allow for the effective guarantee of sub-custodians. The effect of this stand-off has been that in these jurisdictions, prime brokers have been severely restricted in their ability to fully offer their traditional services cross-border. It should also be noted that such a requirement is inconsistent with the Level II MIFID legislation mentioned above.

- The third model is a compromise or "intermediate" model; a domestic custodian is required but the rules relating to the provision of custody services require the custodian to take only reasonable care and skill in the selection and monitoring of sub-custodians. They are not liable for their fraud or failure. Consequently, domestic custodians do not need to impose higher standards upon prime brokers when delegating custody duties. Although this model allows the domestic custodian / prime broker relationship to function, it is still an unnecessary encumbrance upon the efficiency of the hedge fund industry but it does allow it to function. Some observers argue that, of the Member States who have established domestic hedge fund industries, the two which are undergoing the quickest development are the two which have adopted this compromise or intermediate model.

The Group believes that the national provisions setting out custodian responsibility explain in

large part the success of the hedge fund industry in some jurisdictions as against the limited take-off of it in other countries. Given that sophisticated investors are more likely to undertake on-going due diligence, giving them a fuller picture of the operational limits/risks of the hedge fund, its manager and its counterparties, the Group is of the view that the custodian, whether domestic or otherwise, should not bear full liability for asset restitution and sub-custodian performance. Instead, it should only be under an obligation to use reasonable or due care and skill in selecting and monitoring any sub-custodians in accordance with the standards set out in Article 17 of the Level II Directive of MIFID.

The Group is concerned that those national regulators who have sought to create rules under which hedge funds can be authorised have imposed additional layers of control over the activities of the prime brokers. This additional control may act against the interests of investors and significantly reduces the range of markets and instruments such hedge funds can invest in. Hedge funds set up within such constraints will inevitably under-perform as against more traditional funds without a significant reduction in risk. In a market that is defined by absolute returns this can prove fatal. Hedge funds should be encouraged to use prime brokers which are regulated in Member States (or equivalent regulatory regimes) by allowing any such regulated prime broker to act for a hedge fund subject to its own appetite for risk and normal commercial standards of care in appointing sub-custodians. Whether a custodian is located in the same Member State or another Member State, the liability standard should be that of a duty to use reasonable or due care and skill with regard to the selection of and ongoing monitoring of the sub-custodial network.

Some members of the Group noted that in one Member State a type of alternative investment fund exists that, whilst not a true hedge fund, has wider investment capabilities than a UCITS III fund and is aimed at investors that although more expert than traditional retail UCITS investors, are nevertheless not as sophisticated as the traditional offshore hedge fund investor. It could be argued that these intermediate

investors need greater protection and that one way to deliver this is to insist upon a domestic custodian who perhaps has liability for its sub-custodial network. However, such a requirement would, for the reasons given above act as a restriction on the ability of non-domestic service providers to offer their services to such funds, thereby restricting the ability of the fund to generate returns for investors with no real gain in investor protection. If there is a need for greater investor protection then the most appropriate focus is to ensure appropriate behaviour of the manager.

Recommendation # 9: Custodians and prime brokers are established in highly regulated European jurisdictions and are subject to detailed rules governing the provision of custody services. The Group supports a requirement that custodians, whether appointed solely as custodians or as part of a prime brokerage mandate, should be obliged to act reasonably and take due care and skill in monitoring the sub-custodian.

In addition to the requirement that a custodian be regulated in a Member State, the Group would support the use of a minimum assets test by Member States. This would mean that a regulated firm that is appointed as a custodian to a European hedge fund would be subject to a minimum assets test and/or a requirement that the custodian or its ultimate parent hold a specified credit rating.

The Group recommends that Member State regulators and the Commission should seek to reduce regulatory discrepancies in this respect, especially in light of the intended harmonising effect of MiFID, with particular regard to the sections dealing with custody of client assets and the prohibitions against "gold-plating" the Level II provisions in domestic implementing legislation.

4.2. Re-hypothecation

Re-hypothecation is a term of art used to describe use by the prime broker of assets belonging to a hedge fund. The commercial driver behind re-hypothecation is the fact that prime brokers lend cash and securities to hedge

funds and that capital to support these activities has itself to be raised. In simple economic terms, the use of hedge fund assets by prime brokers is a key factor in reducing borrowing costs, thereby increasing returns, for hedge funds. Any assets which a prime broker has used or re-hypothecated will cease as a legal matter to belong to the hedge fund and the hedge fund will acquire a right to the redelivery of equivalent assets from the prime broker. In the event of an insolvency of either party, the obligation to redeliver will be given a cash value and will form part of a set off calculation against the amount the fund owes the prime broker. To the extent that the prime broker has re-hypothecated assets in excess of the amount that the hedge fund owes then the hedge fund would be an unsecured creditor for that excess following the operation of set-off. Against that risk, the more assets a prime broker is able to use, the lower overall cost of funding that hedge funds have to pay.

In some jurisdictions concerns over prime broker insolvency have driven legislative restrictions on the amount of assets that can be re-hypothecated in excess of the fund's current indebtedness to the prime broker. Restrictions have been observed as low as 100% for 140% of indebtedness and in some jurisdictions, that limit is a percentage of the net asset value of the hedge fund and not its indebtedness to the particular prime broker. The effect of these restrictions is a net increase in financing and securities borrowing costs for funds in these jurisdictions compared with the costs for hedge funds established in jurisdictions which do not impose such a limit. These higher costs act to reduce the returns available to investors, restrict the appetite of the providers of leverage to become involved in a "zero sum game" and combine to militate against the jurisdiction as one of choice for fund promoters and service providers.

The rationale behind a limit on re-hypothecation is clearly a concern to protect the investor against the risk of default of the prime broker. However, the cost of achieving that goal must be balanced against the other needs and the sophistication of the investor. Prime brokers are international investment banks subject to

prudential supervision under the Capital Requirements Directive.

The Group believes therefore that rather than imposing an artificial limit, direct tools exist to manage the risk of default of the prime broker, as addressed in the European Union banking prudential rules. As a consequence, there is no need to build in "double lock" protection. Ideally, the strict limits of re-hypothecation should be negotiated as part of the commercial terms of business between the fund and the prime broker.

Recommendation # 10: Re-hypothecation limits are a critical economic variable contributing to the cost and price of providing the prime brokerage service. Prime brokers are established in highly regulated Member States and are subject to detailed rules governing the provision of regulated services.

The Group recommends that neither Member States nor the Commission impose any regulatory restrictions upon re-hypothecation limits for European hedge funds and that such matters be regarded as commercial terms of business to be negotiated between the fund and the prime broker. Any right of re-hypothecation should, however, be transparent to investors through the medium of disclosure in the fund offering documents. The Group would support any requirement, either at Member State or Community level, that a right of re-hypothecation be coupled with an enforceable set-off clause in the brokerage documentation.

However, if a ceiling is considered necessary and supervisors insist on imposing some limit for investor protection reasons through further banking/prudential rules, then it is appropriate:

- to measure that limit by reference to the level of indebtedness rather than by reference to the NAV of the fund. A prime broker can determine on any day how much the fund owes it but it cannot easily track the NAV because calculating this requires more information than is available to each prime broker, especially**

as most large funds now have more than one prime broker;

- to couple limitation on re-hypothecation with close-out netting provisions which would enable the setting off of the prime broker’s redelivery obligation against the fund’s liabilities to the prime broker; and
- to ensure that each Member State recognises that a prime broker regulated in another Member State is entitled to provide prime brokerage services (for example, custody, clearing, stock and cash lending, and research) to hedge funds regulated within its territory.

4.3. *The challenge of hedge fund asset valuation*

The calculation of hedge fund net asset value or “NAV” is a vital task because the price at which investors purchase and redeem the shares or units of the fund is based on the NAV, as is the level of management fees paid to the manager. NAV calculations are complex but not difficult when undertaken by a reliable third-party fund administrator. The widely acknowledged challenge facing the hedge fund industry is the issue of the asset valuations that form the inputs to the NAV calculation. Many assets traded by hedge funds do not present a valuation problem as they are traded on a recognised exchange or another liquid market and quotes and prices are readily available from recognised reputable pricing sources such as Bloomberg or Reuters. Valuation becomes more of an issue with illiquid or unquoted assets and highly structured derivative products, created by and sold by certain financial institutions. For these illiquid or unquoted securities, a valuation is often difficult to determine and may be based upon an estimate (through well tested models) prepared either by the manager or by a third-party provider. In the case of highly structured products the ability to derive a realistic value resides only with the highly skilled traders and structurers at the investment banks that sell the products or the hedge fund managers that buy them, not with third party administrators or pricing service providers.

If the investment manager is calculating the value of the fund, a metric by which its level of

fee revenue is measured, there is potential conflict of interest between the hedge fund manager and the investors. Despite this, the traders/portfolio managers of an appropriately regulated hedge fund manager are in fact often better placed than third-party valuation agencies or administrators to value complex positions. There are third-parties (a small number of administrators and specialist valuation agents) who are prepared to offer a full valuation service. However, in reality the level of compensation within the administration/valuation sector of the hedge fund industry is not at a level that allows these entities to retain and remunerate highly skilled structurers and traders with the relevant experience and expertise to value such complex positions accurately.

One method, among others, that may offer advantages in addressing this potential conflict of interest is the “managed account” structure. In such structures, the traditional role of the manager is divided between the “trading advisor”, which manages the day to day positions of the fund, and the “manager”, which follows the risks and makes sure investment guidelines are respected, but also supervises and controls the valuation made by the administrators. In some of these structures, the valuation for the fund can be undertaken independently of the trading advisor.

It is true that third-party vendors are increasingly trying to offer competent valuations in respect of complex assets; however, in the short to medium term, there remain doubts as to the reliability of the services provided by these participants. One concern with complex positions is that there are no standardised pricing references. However, large banks and broker dealers, including prime brokers, are increasingly finding themselves in the position of intermediating third-party OTC’s transactions between client hedge funds and executing brokers, and as a result their valuations on such positions may be used. These valuations are not independent as the brokers are a principal party to the intermediated transactions; however, such valuations are often required to be made in good faith and can prove a useful reference source for

any manager or other party preparing a fund valuation.

The Group wishes to make it clear that the issue of valuations and the headline topics described briefly above are of relevance to the global hedge fund industry and not simply the industry in Europe.

As regards hedge fund assets' valuation, AIMA, on a global basis, has issued 20 recommendations²⁷ to investment managers and administrators. Furthermore, IOSCO²⁸ has decided that a set of valuation principles may generally prove of value to collective investment schemes' regulation and global markets. IOSCO's standing committee n° 5 (SC5) received a mandate on "hedge funds valuation and administration". The approach proposed by SC5 is based on an interaction process with the industry, notably with an AIMA working group, on the key issues relating to the valuation of hedge funds. The final output in the shape of draft principles is expected for public consultation at the 2007 annual meeting of IOSCO.

Finally, the Group point out that investors undertake ongoing due diligence allowing them to check the methodology of asset valuation. The hedge fund servicing industry is increasingly specialised and professional. The prevailing view amongst industry experts is that the valuation of hedge fund assets is not an issue that can be addressed by legislation or the imposition of a requirement for an independent third party. Valuation is most appropriately managed by adherence to industry-led codes of conduct and best practice coupled with transparency of the valuation process for investors. The Group is of the same view and would urge that Member States refrain from implementing regulatory requirements in respect of valuation which might serve to

²⁷ AIMA "Asset Pricing and Fund Valuation in the Hedge Fund Industry", April 2005

²⁸ The [International Organisation of Securities Commissions](#) is composed of financial market regulators at global level which cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets.

restrict the growth of the hedge fund industry in Europe.

Recommendation # 11: As regards asset valuation, considering the global nature of hedge fund operation and the active participation of most Member State regulators in the IOSCO Standing Committee n° 5, the Group does not wish to pre-empt the IOSCO report and make specific recommendations at this time. Nevertheless, the Group is hopeful that IOSCO will not recommend the need for direct regulation or legislation in respect of hedge fund valuation and that it will advocate a system of best practice that relies upon industry led codes of conduct and permits different levels of independence in relation to the valuation function coupled with transparency for investors through full disclosure, thus allowing hedge fund investors to take the level of independence of the valuation function as well as the methodology into account as part of the due-diligence prior to investing.

Conclusion

The European hedge fund industry has the potential to become a strong pillar of the European financial system. The Group welcomes this opportunity to put forward suggestions as to how policy makers can help to build on this success. It hopes that it has helped to clear up some of the misconceptions about hedge funds.

The hedge fund industry has grown to meet demand from investors for a wider range of products. This demand continues to grow because the industry continues to meet those requirements. The development of sophisticated financial products has created a virtuous circle whereby more and more investors are beginning to see the advantages of absolute return investment strategies.

Policy makers should reconsider whether, in seeking to protect investors, they are inadvertently denying those same investors access to the products and fund managers that are most capable of meeting their investment needs.

ANNEX

TABLE 1: OVERVIEW OF NATIONAL REGULATORY REGIMES

Country	Regulated products	Retail	Minimum
France	<i>OPCVM à règles d'investissement allégées (ARIA) and OPCVM ARIA à effet de levier (ARIAEL)</i>	Yes	€ 125.000 ²⁹
	<i>OPCVM contractuels</i>		€ 250.000
	<i>OPCVM de fonds alternatifs (funds of hedge funds)</i>	Yes	€ 10.000 ³⁰
Germany	<i>Sondervermögen mit zusätzlichen Risiken (Hedgefonds)</i>	No, but private placement possible	None
	Fund of hedge funds	Yes	
Ireland	Professional Investor Fund	No	€ 125.000
	Qualifying Investor Fund		€ 250.000
	Fund of hedge funds	Yes	None
Italy	<i>Fondi speculativi</i> Speculative fund	No	€ 500.000
	Fund of hedge funds		
Luxembourg	Undertakings for collective investment pursuing alternative investment strategies	Yes	None
Portugal	<i>Fundo Especial de Investimento</i>	Yes	€ 15.000
Spain	IIC de Inversión libre	No	€ 50.000
	<i>IIC de IIC de Inversión Libre (Fund of hedge funds)</i>	Yes	None
United Kingdom	Qualified Investor Scheme	No	None
	Fund of hedge funds	Yes	

²⁹ There is no minimum investment for qualified investors or non France-based investors.

³⁰ No minimum investment threshold provided that there is a capital guarantee or for non-French investors.

TABLE 2: INVESTOR RESTRICTIONS ON HEDGE FUND INVESTMENTS

VARYING TREATMENT IN EUROPE MEMBER STATES

Member State	Insurance Companies	Pension Funds
France	<ul style="list-style-type: none"> ➤ Allowable subject to severe restrictions ➤ Up to 10% of eligible assets in hedge fund, PE and non-regulated funds <u>so called "other assets ratio"</u> ➤ Foreign funds, if UCITS yes, if not fall under non-regulated funds, above 	<ul style="list-style-type: none"> ➤ Not allowable ➤ AGIRC and ARRCO 05 guidelines ➤ Forbid access to hedge funds or funds of hedge funds ➤ Sometimes access possible via structured products, under certain conditions
Germany	<ul style="list-style-type: none"> ➤ Allowable subject to restrictions ➤ White funds only (and limited choice) ➤ Can buy certificate and package ➤ Limited to 5% of assets 1% in each fund ➤ Restriction on foreign funds which must be managed in EEA regulated company ➤ Must respect risk ratio 	<ul style="list-style-type: none"> ➤ Allowable subject to restrictions ➤ "Pensionskasse" (traditional occupational schemes) are subject to the same restrictions as insurance companies (see above) ➤ "Pensionsfonds" (more recent form of occupational schemes) are not subject to the same quantitative investment restrictions but are restricted by the requirement to invest in white funds/certificates with tax transparency
Italy	<ul style="list-style-type: none"> ➤ Not allowable ➤ ISVAP refused to relax rules despite lobby from Italian industry ➤ Structured products – <u>not</u> acceptable ➤ <u>Tax</u> Italian funds favoured by lower 12.5% rate. Therefore investments typically via Italian SGRs 	<ul style="list-style-type: none"> ➤ Allowable ➤ YES: subject to quantitative restrictions typically 15% of pension fund assets. ➤ 5% maximum for non OECD products.
The Netherlands	<ul style="list-style-type: none"> ➤ Allowable - No restrictions other than prudent, diversified investment using agreed risk management tools 	<ul style="list-style-type: none"> ➤ Allowable - No restrictions other than ALM to determine ALM surplus funds and no increase in overall risk
Spain	<ul style="list-style-type: none"> ➤ Not allowable ➤ No for <u>technical provisions</u> but new rules could allow allocation to Spanish funds ➤ Foreign funds may also be possible if managed in OECD – up to 10% ➤ No restrictions on free capital 	<ul style="list-style-type: none"> ➤ Not allowable except if based in Basque country.
United Kingdom	<ul style="list-style-type: none"> ➤ Allowable subject to restrictions ➤ Limited by capital resources requirement ➤ invested in "admissible assets" ➤ If CIS – they must invest in admissible assets ➤ If hedge funds not admissible assets not likely to be attractive 	<ul style="list-style-type: none"> ➤ Allowable ➤ Required to invest primarily in regulated markets ➤ May therefore prefer listed hedge funds ➤ Limited use of derivative contracts means very restricted use of managed accounts

LIST OF THE GROUP'S 11 RECOMMENDATIONS

Recommendation # 1: Member States should recognise the broadening investor appetite for hedge funds and related products by developing a regulatory approach that is compatible with these needs and the organisation of the hedge fund business.

The Group recommends that European authorities and supervisors allow the provision of investment services in respect of the full range of hedge funds and related products by investment firms authorised in accordance with MiFID – without imposing additional restrictions or formalities at the level of the fund, its manager or other participants in the value chain.

In particular, the Group recommends that regulators do not seek to control sales and distribution through product regulation or registration. The Group is of the view that regulators should focus, instead, on two levels of protection:

- First, the Group recommends that conditions be introduced to prevent access to hedge funds by investors for whom such investments are not suitable. A majority of Group members considered a minimum threshold of 50'000€ would satisfy this condition. A substantial minority considered that a higher threshold and/or other safeguards should apply;
- Second, the Group recommends the enforcing of clear conduct of business requirements on the intermediaries and institutions who conclude sales contracts with end-investors. This is an appropriate and efficient means of providing the graduated level of protections required by different investor categories.

Recommendation # 2: The majority of the Group recommends against reopening negotiations on the key provisions of the UCITS Directive with a view to facilitating the authorisation of a broad range of funds of hedge funds as UCITS. A minority considered that the time was right to broaden investment rules and other provisions of the UCITS directive to allow funds of hedge funds to be authorised as UCITS compliant funds.

Recommendation # 3: The Group recognises the potential value in allowing retail investor access to hedge fund based investing by authorising UCITS to invest in derivatives on hedge fund indices. However, the majority of the Group recognises the validity of concerns regarding the reliability and functioning of hedge fund indices. The Group, with exception of one member, recommends that UCITS investment in derivatives based on such indices be deferred until concerns regarding the structure and performance of hedge fund indices are resolved.

Recommendation # 4: Whilst concerned about the limitations associated with product regulation, the Group recommends that the European institutions and national authorities take all non-legislative steps needed to give effect to the mutual recognition of (nationally regulated) retail-oriented hedge fund products. These should be mutually recognised as suitable for sale to the investing retail public across the European market and for distribution under MiFID conditions. This should not be considered as a substitute for other reforms suggested with regards to improving the distribution regime for non-retail oriented funds.

Recommendation # 5: Regulators and industry bodies should remove absolute or arbitrary quantitative restrictions on hedge fund based investing which are imposed on some institutional investors. The Group advocates removal of any arbitrary and/or regulatory prohibition or restriction. The "prudent man" principle which informs the Directive on the activities and supervision of institutions for occupational retirement provision (IORP) should be more broadly applied.

Recommendation # 6: The Group recommends that effective steps be taken to ensure a measured and appropriate implementation of the Capital Requirements Directive – one which does not result in exaggerated and prohibitive restrictions on bank investment in hedge funds. The European Commission and Committee of European Banking Supervisors should, at an early stage of the implementation of the Basle II framework, compare and reconcile the trading book rules in each Member State as well as how they are construed and applied by the competent supervisory authorities. Guidance is particularly needed in respect of the level of transparency that regulators should require when allowing banks a more favourable “look-through approach”.

In addition, the Group recommends that the European Commission provide for appropriate provisioning requirements under its forthcoming proposals for Solvency II. The forthcoming draft Directive should not impose excessively onerous reserve requirements which would represent an unjustified deterrent to investment in hedge funds by life-insurers.

Recommendation # 7: The Group urges the European Union and national authorities to enter into negotiations with the US Securities & Exchange Commission and other relevant parties with a view to securing exemption from the US registration requirements for European hedge fund managers who are already registered with a Member State authority and are doing business with US qualified investors. If new regulations are put in place due to the US Court of Appeals decision, the Group urges the European Union Commission to make appropriate comments and to enter into negotiations so that the final regulations that are put in place do not have adverse consequences for the European Hedge Fund industry and to specifically ensure that no dual registration is required for managers already regulated in Member States.

Recommendation # 8: An absolute requirement for a local entity to perform custody functions for European hedge funds does not significantly increase the level of investor protection available above that required by such sophisticated hedge fund investors; in reality it restricts the ability of managers to generate returns which in turn impedes the ability of the European hedge fund industry to grow and compete in the global market place. Such requirements also prevent the provision of cross border services by custodians in other Member States and stifle competition.

Member State regulators should not impose a requirement for the appointment of a domestic custodian upon European hedge funds. The Group recommends that the provider of custody services to a European hedge fund should be a regulated provider of custody services, either domestically or in another Member State together with a minimum assets requirement.

Recommendation # 9: Custodians and prime brokers are established in highly regulated European jurisdictions and are subject to detailed rules governing the provision of custody services. The Group supports a requirement that custodians, whether appointed solely as custodians or as part of a prime brokerage mandate, should be obliged to act reasonably and take due care and skill in monitoring the sub-custodian.

In addition to the requirement that a custodian be regulated in a Member State, the Group would support the use of a minimum assets test by Member States. This would mean that a regulated firm that is appointed as a custodian to a European hedge fund would be subject to a minimum assets test and/or a requirement that the custodian or its ultimate parent hold a specified credit rating.

The Group recommends that Member State regulators and the Commission should seek to reduce regulatory discrepancies in this respect, especially in light of the intended harmonising effect of MiFID, with particular regard to the sections dealing with custody of client assets and the prohibitions against “gold-plating” the Level II provisions in domestic implementing legislation.

Recommendation # 10: Re-hypothecation limits are a critical economic variable contributing to the cost and price of providing the prime brokerage service. Prime brokers are established in highly regulated Member States and are subject to detailed rules governing the provision of regulated services.

The Group recommends that neither Member States nor the Commission impose any regulatory restrictions upon re-hypothecation limits for European hedge funds and that such matters be regarded as commercial terms of business to be negotiated between the fund and the prime broker. Any right of re-hypothecation should, however, be transparent to investors through the medium of disclosure in the fund offering documents. The Group would support any requirement, either at Member State or Community level, that a right of re-hypothecation be coupled with an enforceable set-off clause in the brokerage documentation.

However, if a ceiling is considered necessary and supervisors insist on imposing some limit for investor protection reasons through further banking/prudential rules, then it is appropriate:

- to measure that limit by reference to the level of indebtedness rather than by reference to the NAV of the fund. A prime broker can determine on any day how much the fund owes it but it cannot easily track the NAV because calculating this requires more information than is available to each prime broker, especially as most large funds now have more than one prime broker;
- to couple limitation on re-hypothecation with close-out netting provisions which would enable the setting off of the prime broker's redelivery obligation against the fund's liabilities to the prime broker; and
- to ensure that each Member State recognises that a prime broker regulated in another Member State is entitled to provide prime brokerage services (for example, custody, clearing, stock and cash lending, and research) to hedge funds regulated within its territory.

Recommendation # 11: As regards asset valuation, considering the global nature of hedge fund operation and the active participation of most Member State regulators in the IOSCO Standing Committee n° 5, the Group does not wish to pre-empt the IOSCO report and make specific recommendations at this time. Nevertheless, the Group is hopeful that IOSCO will not recommend the need for direct regulation or legislation in respect of hedge fund valuation and that it will advocate a system of best practice that relies upon industry led codes of conduct and permits different levels of independence in relation to the valuation function coupled with transparency for investors through full disclosure, thus allowing hedge fund investors to take the level of independence of the valuation function as well as the methodology into account as part of the due-diligence prior to investing.

COMPOSITION OF THE EXPERT GROUP ON HEDGE FUNDS

Members

	Name	Surname	MS	Company
Mr	Segun	Aganga	UK	Goldman Sachs
Mr	Antonio	Ary dos Santos Freire	P	Santander
Ms	Odette	Cesari	FR	Axa-IM
Mr	Neil	Donnelly	IRL	Pioneer
Mr	Alain	Dubois	FR	Lyxor
Mr	Horst	Eich	DE	Allianz
Mr	Paul	Feeney	UK	Gartmore
Mr	Holger	Hartenfels	DE	Deutsche Bank
Ms	Gay	Huey Evans	US	Citigroup-Tribeca
Mr	Alain	Reinhold	FR	ADI
Mr	Rupert	Rossander	CH	MAN
Mr	Lindsay	Tomlinson	UK	BGI
Mr	Jack	Tracy	UK	Morgan Stanley
Mr	Luc	de Vet	LUX	Citco
Mr	Neil	Warrender	UK	RAB Capital
Mr	Damian	Neylin	IRL	PricewaterhouseCoopers

Observers

	Name	Surname	MS	Organisation	Stakeholder group
Ms	Jella	Benner-Heinacher	DE	DWS/Euroshareholders	Retail investors
Mr	Robert	Coomans	NL	ABP pension fund	Wholesale investors
Mr	Gernot	Karl Heitzinger	AUT	SMN Investment Services	Wholesale investors
Ms	Florence	Lombard	INT	AIMA	Industry
Ms	Tatiana	Verrier	DE	DB/FIN-USE	Retail investors
Ms	Philippa	Dodd	NL	UNICE	Corporate
Ms	Barbara	Stearns-Blasing	EU	UNICE	Corporate
Mr	Carlo	Comporti	EU	CESR	Regulators
Mr	Fabio	Recine	EU	European Central Bank	Banking supervisors

Chairman

Mr	Niall	Bohan	EU	European Commission
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Secretary

Mr	Patrice	Bergé-Vincent	EU	European Commission
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