Submission

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CREATING LASTING VALUE

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Proposal for a Directive on enhanced cooperation implementing a Financial Transaction Tax

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Executive Summary:

The European private equity and venture capital industry ('private equity') has reservations about the proposed Financial Transaction Tax (FTT) for the following reasons:

- In taxing an industry which provides financing for European SMEs, the FTT will not contribute to Europe's urgent challenges of achieving economic growth and higher employment, but will hamper long-term investment by making such investment more costly.

- Private equity was not a cause of the economic crisis, as acknowledged by the De Larosière Report.

- Private equity does not cause systemic risk, as the European Commission has recognised.

- The effective tax rate on private equity funds will be much higher than the nominative rate contained in the proposal due to the cumulative impact of the FTT. Research indicates that the effective rate is likely to be 0.6% - 0.8% for a simple private equity fund, which could rise to 1.4% for funds investing on a cross-border basis.

- The FTT will ultimately result in negative net revenue for national exchequers. It will increase the cost of raising capital and thus discourage investment in the real economy, dampening business growth, which will result in lower income tax and corporation tax receipts.

- The primary market exemption for issuance of units/shares in collective investment undertakings will not be sufficient to avoid increasing the cost of raising capital for private equity funds as the whole sequence of raising capital, investing it and providing returns is one inter-connected investment chain.

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Introduction:

The biggest challenges which the EU faces are: (i) achieving sustainable growth, and (ii) generating higher employment in all Member States.

These are not straight-forward challenges to meet, since Europe faces, in parallel, the challenges of global competition and an ageing population. Competition from economies outside the EU requires Europe to continue to encourage companies to locate and invest here. An ageing population, meanwhile, makes adequate, sustainable and cost-effective retirement provision essential. These goals necessitate long-term investment and the FTT, as with all EU policies, must be measured against this backdrop. But the FTT fails against both.

Private equity invests in the real economy, i.e. businesses which produce products and services and in so doing generate employment. In stark contrast to speculative activity on non-real economy based assets private equity investors are patient investors in thousands of real businesses. Private equity funds have invested €271 billion in Europe since 2007,[1] and research shows that private equity backed Small and Medium-sized Enterprises (SMEs) experience greater growth in sales, assets and employment than those not backed by private equity.[2] **European private equity firms provide financing to about 5,000 companies per year, of which 83% are SMEs.[3]** The average holding period in these companies is five years.[4]

Impact on Long-term Investing:

Numerous studies have demonstrated that the costs of the proposed FTT will be borne by investors and/or savers.[5] One study estimates that long-term investors such as pension funds and insurance companies, important investors for the private equity industry, will directly pay € 10-15 billion annually.[6] This is attributable to the fall in asset values as a result of higher future transaction costs and lower future cash-flow expectations. **Research suggests that given the costs of the tax, pension funds will consider options such as investing in funds outside the FTT zone**.[7]

In this vein, the private equity Industry would like to re-iterate its long-standing commitment to encouraging and facilitating long-term investing. This sentiment has also been espoused by the European Commission in recent publications such as the Green Paper on Long-term Financing of

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[1] EVCA/PEREP_Analytics, 2012

[2] Boucly et al, Journal of Financial Economics, 2011

[3] EVCA/PEREP_Analytics, 2012

[4] EVCA/PEREP_Analytics, 2011, and Strömberg 2009, SSRN Working Paper

[5] Oxera, *Analysis of European Commission staff working document on the proposed FTT*, May 2013
ADM Risk, Regulation and Strategy Report for the International Regulatory Strategy Group, *A Financial Transaction Tax – Review of Impact Assessments*, March 2012

[6] Oliver Wyman, *The Impact of the EU-11 Financial Transaction Tax on End-Users*, November 2013, pp3

[7] Supra 5, Oxera, pp 17

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the European Economy[8] and the Proposal for a Regulation on European Long-term Investment Funds.[9] In the former, the Commission identified the development of the venture capital sector as a potential solution to the difficulties SMEs face in accessing finance.[10]

Long-term investment needs a stable and predictable regulatory and fiscal environment. In this light, it appears counterproductive for the EU to pursue both these specific initiatives on long-term investing and an FTT. The introduction of an FTT would make long-term investment more difficult and more costly.

Similarly, the recently adopted MiFID[11] package would appear to be at odds with the proposed FTT. The former aims to harmonise and integrate the EU market for financial instruments, while the latter will inevitably result in the fragmentation of that market, between the participating EU 11 Member States and the rest.

Furthermore, such fragmentation risks undermining the AIFMD passport used by private equity Managers, creating new tax distortions. Fund Managers seeking to fundraise in different participating Member States will face different FTT rates, and when they move into non-participating Member States national taxes on investment activity will also be applied, threatening double taxation. While it is true that there is currently a lack of coordination on such taxes we believe that the use of enhanced cooperation risks entrenching rather than ameliorating this problem.

According to Recital 8 of the Proposal, "*the trade on primary markets…..should be excluded from the scope of the FTT, so as not to undermine the raising of capital by companies and governments…*" Despite this provision, the proposed FTT will have the exact effect of undermining the raising of capital by private equity funds. The issuance of shares/units in private equity funds will be exempt from the tax due to the primary market exemption, which we welcome and should be maintained. Nevertheless, the redemption of shares/units in these funds will not be exempt from the tax, and one cannot and should not attempt to look at the redemption of shares/units of private equity funds in isolation.

Rather, as illustrated in the following diagram, the whole sequence of raising capital from institutional investors (such as pension funds and insurance companies), investing that capital via long-term, closed-ended funds (typically for ten years or more) into companies, often via holding structures, and then providing returns to investors, is one inter-connected investment chain.

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[8] European Commission, Green Paper: Long-term Financing of the European Economy, March 2013

[9] European Commission, Proposal for a Regulation on European Long-term Investment Funds, June 2013

[10] Supra 8, pp 17

[11] Proposal for a Directive and Regulation on Markets in Financial Instruments, February 2014

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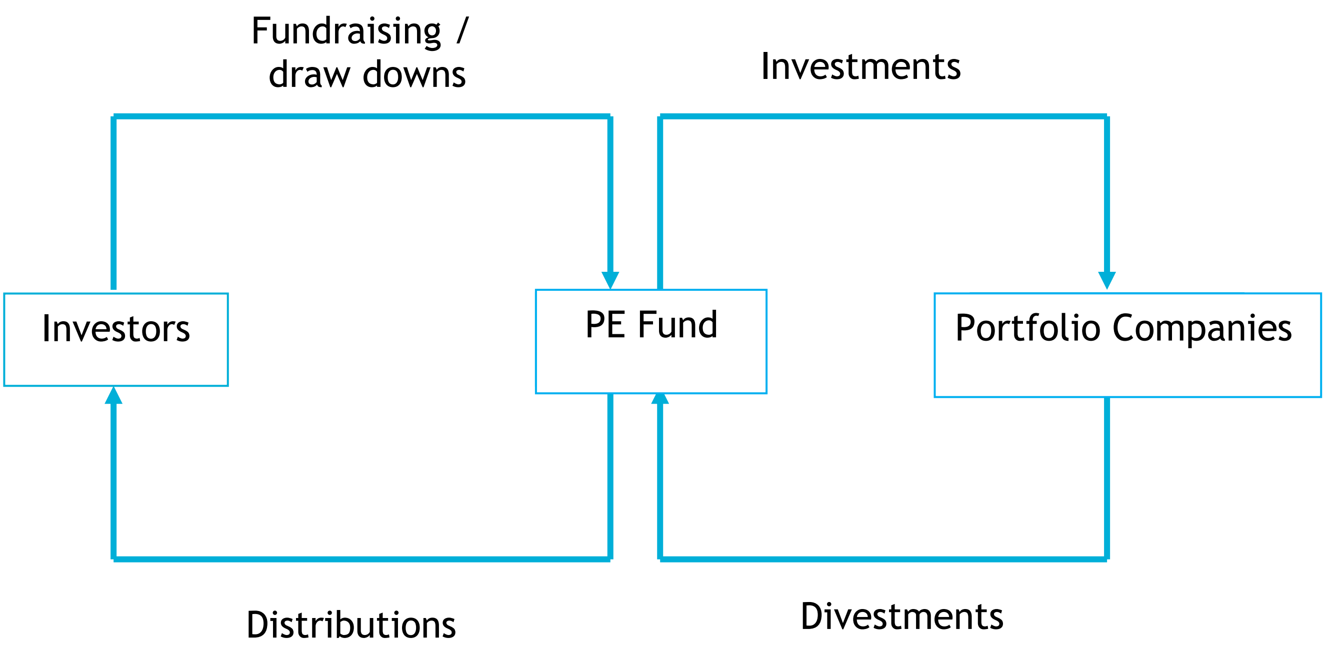

As can be seen, each step of the fund is not an individual, stand-alone transaction. Furthermore, at the end of the life-cycle of the fund, if the investors are satisfied with their returns, they often then re-invest the returns they receive as capital and the cycle starts once more. **If the end result of an FTT is to negatively impact the returns to investors, then those investors will be discouraged from investing in the first place due.**

The level of taxation of these redemptions is substantial. Despite the apparently low minimum rates contained in the Commission Proposal, the cumulative effect of applying the FTT to a single, simple private equity structure **leads to an initial estimate of the aggregate FTT rate of 0.6% to 0.8% on the gross amount of the investment in the beneficiary company.** This is contained in a comprehensive analysis of the impact of the proposed FTT on private equity.[12] This estimate is based on the minimum rates contained in the Proposal and without the inclusion of any hedging activity or the raising of further capital.[13]

More dramatically, if a significant portion of the private equity structure (including the fund) is located in an EU Member State which is not one of the participating 11 Member States, then any relevant national tax in force in that jurisdiction is also applicable. **This scenario would result in**

[12] ADM Risk, Regulation and Strategy, *A report for the EVCA on the implications of a Financial Transaction Tax (FTT) for private equity*, January 2014

[13] Ibid, case 1a, pp 21

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double taxation and could lead to an effective tax rate of 1.2% to 1.4%, depending on the locality[14]. Such cases highlight the failure of the Proposal to take into consideration important questions such as the interplay between applicable taxes outside the EU11 Member States and the FTT. Conversely, if a significant portion of the structure of a private equity fund is established in a third country, then the effective rate will fall to between 0.2% and 0.4%.[15]

The combined effect of these factors will be to make the EU a more difficult and more costly place in which to raise and invest long-term capital. At the same time, the Proposal is highly unlikely to achieve its own objectives.

Objectives of the FTT:

The Explanatory Memorandum[16] and Recital 1 of the Proposal identify 4 principal objectives for an FTT: (i) ensure that the financial sector makes a fair and substantial contribution to covering the costs of the recent crisis, (ii) dis-incentivise excessively risky activities by financial institutions, (iii) complement regulatory measures aimed at avoiding future crises, and (iv) generate additional revenue for general budgets or specific policy purposes. We would like to address each of these points individually.

(i) Ensure that financial institutions make a fair and substantial contribution to covering the costs of the recent crisis:

In the De Larosière Report's assessment of the causal effects of the financial crisis, the private equity industry is not identified as a contributing factor.[17] Private equity did not cause the crisis, and therefore should not be expected to meet its costs.

According to the explanatory memorandum of the Proposal, "[t]*here is a strong consensus within Europe and internationally that the financial sector should contribute more fairly given the costs of dealing with the crisis and the current under-taxation of the sector*." In our view, the proposed FTT would require the private equity industry to *unfairly* and disproportionately contribute to the cost of the crisis, resulting perversely in an increase in the cost of raising capital for investing in growth and innovation.

(ii) Dis-incentivise excessively risky activities:

The proposed FTT is overtly aimed at taxing risky activities, yet private equity funds are, by their nature, "not likely to cause systemic risk" according to the Commission.[18] Private equity makes a

[14] Ibid, cases 2a and 2b, pp 40 and 43
[15] Ibid, cases 1e and 1f, pp 34 and 37
[16] See Sections 1.1 and 1.2 of the Explanatory Memorandum to the Commission Proposal on FTT
[17] Report of the High-Level Group on Financial Supervision in the EU chaired by Jacques De Larosière, February 2009

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significant contribution to the real economy in Europe which must be protected. Investments in and by private equity funds are not financial transactions in the spirit of the Proposal.

(iii) Avoid future crises:

Private equity funds are not systemically important financial institutions and do not employ leverage on a substantial basis. Because of this, in the unlikely event of a private equity fund becoming insolvent, there will be no systemic implications for the financial system. Investors would not, in this unlikely scenario, receive their expected rate of return but there would be no system-wide impact requiring taxpayer bailouts.

Since the onset of the economic crisis, several measures, such as the introduction of the AIFM Directive have been adopted to further regulate private equity.[19] The adoption of the AIFMD has given the private equity a robust new regulatory framework, protecting investors and the wider financial system.

In addition, the three new European Supervisory Authorities[20] were established in 2011. The European Securities and Markets Authority (ESMA) is empowered to draft level II standards and to ensure consistency in day-to-day implementation of EU law in this area. The private equity industry, with a proven track-record of being non-systemically important, is now regulated by a significantly enhanced oversight regime. In this light, **it is clear that the FTT is a blunt tool with which to address an asset class such as private equity within the "financial institutions" bracket.**

(iv) Generate additional revenue:

Imposing an FTT on private equity risks being a backward step in this regard. The proposed FTT will be applicable at numerous different levels of the same private equity fund, which will have a detrimental impact on investor returns. This will naturally discourage investors from investing in the first place and will lead to significantly reduced levels of financing for European companies. This prospect is particularly worrying in light of the continuing decrease in bank lending in Europe.[21] Private equity has, in many cases, stepped in to fill this gap and at the same time provides benefits beyond debt financing. According to the ECB, private equity investments stimulate innovation and in particular cause a significant increase in patent filings.[22] This lack of business financing may ultimately translate into less growth with negative knock-on effects on

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[18] Proposal for a Directive on Alternative Investment Fund Managers, April 2009, pp 6

[19] Alternative Investment Fund Managers Directive, Directive 2011/61

[20] The European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA). Regulation 1095/2010 establishing ESMA

[21] European Central Bank, The Euro Area Bank Lending Survey, July 2013

[22] Popov and Roosenboom, ECB Working Paper, *Does Private Equity Investment Spur Innovation? Evidence from Europe*, June 2009

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employment, corporation tax, income tax, thus cancelling out the money received from taxing the private equity Industry.

Conclusion:

Taxes do not create jobs, private equity does.[23]

As investments in, and by, private equity lead to growth in the real economy; pose no systemic risk; did not contribute to but rather mitigated the effects of the financial crisis; and remain an important means to deploy much needed capital into the real economy, such investments should rest outside the scope of the proposed FTT.

The implications of the proposed FTT are clear. It will increase the cost of raising capital, thereby compromising the ability of private equity to channel global pools of capital into SMEs to allow them to grow and expand.

Indeed, the impact of the proposed FTT on investment from third countries into the EU should not be underestimated. The FTT's introduction may discourage their continued investment into the region. In 2012, non-European private equity funds invested 800 million euro in European companies.[24]

In addition to the direct impact of the introduction of an FTT, there are other, important knock-on effects, such as indirect costs. Each taxable transaction will trigger a plethora of administrative obligations that will require the affected financial institution to navigate a patch-worked and complex legal landscape, involving different laws in different Member States.

Finally, the Proposal raises important questions which remain unanswered. For example, are distributions (as opposed to redemptions) from private equity funds taxable? The definitive answer to this and other questions will not be apparent until each of the participating 11 Member States drafts their implementing legislation. Such uncertainty further damages investor confidence.

In the following Annex, we provide specific draft amendments in order to ensure appropriate treatment of our industry.

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[23] Boucly et al, Journal of Financial Economics, 2011
[24] EVCA/PEREP Analytics.

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Annex 1 – EVCA Draft Amendments

Chapter 1 – Subject Matter and definitions

Commission Text	**EVCA Draft Amendment**
Article 2 *Definitions* 1. For the purposes of this Directive, the following definitions shall apply: (3) 'Financial instruments' means financial instruments as defined Section C of Annex I to Directive 2004/39/EC of the European Parliament and of the Council, and structured products; (8) 'Financial institution' means any of the following: (g) an alternative investment fund (AIF) and an alternative investment fund manager (AIFM) as defined in Article 4 of Directive 2011/61/EU of the European Parliament and of the Council;	*Article 2* *Definitions* 1. For the purposes of this Directive, the following definitions shall apply: (3) 'Financial instruments' means financial instruments as defined Section C of Annex I to Directive 2004/39/EC of the European Parliament and of the Council ***(except for units in collective investment undertakings where those undertakings are Alternative Investment Funds (AIFs) of the closed-ended type which do not employ leverage on a substantial basis)***, and structured products; (8) 'Financial institution' means any of the following: (g) an alternative investment fund (AIF) and an alternative investment fund manager (AIFM) as defined in Article 4 of Directive 2011/61/EU of the European Parliament and of the Council ***except for AIFs of the closed-ended type which do not employ leverage on a substantial basis and AIFMs which manage such AIFs*** ;

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Commission Text	EVCA Draft Amendment
(h) a securitisation special purpose entity as defined in Article 4(44) of Directive 2006/48/EC; (i) a special purpose vehicle as defined in Article 13(26) of Directive 2009/138/EC; (j) any other undertaking, institution, body or person carrying out one or more of the following activities, in case the average annual value of its financial transactions constitutes more than fifty per cent of its overall average net annual turnover, as referred to in Article 28 of Council Directive 78/660/EEC:	(h) a securitisation special purpose entity as defined in Article 4(44) of Directive 2006/48/EC; (i) a special purpose vehicle as defined in Article 13(26) of Directive 2009/138/EC; (j) any other undertaking, institution, body or person carrying out one or more of the following activities, in case the average annual value of its financial transactions constitutes more than fifty per cent of its overall average net annual turnover, as referred to in Article 28 of Council Directive 78/660/EEC:, ***except where it is wholly or majority owned by an AIF of the closed-ended type which does not employ leverage on a substantial basis and is not classed as a 'financial institution' under this Article ,***

Chapter II

Scope of the common system of FTT

Commission Text	EVCA Draft Amendment
Article 3 *Scope* 4. This Directive shall not apply to the following transactions: (g) transactions carried out as part of restructuring operations referred to in Article 4 of Council Directive 2008/7/EC.	*Article 3* *Scope* 4. This Directive shall not apply to the following transactions: (g) transactions carried out as part of restructuring operations referred to in Article 4 of Council Directive 2008/7/EC.

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	(h) linked transactions, namely transactions that are carried out after the issuance of units or shares of an AIF of the closed-ended type which does not employ leverage on a substantial basis and is not classed as a financial institution as per Article 2(8)(g)*, and carried out *by that AIF, the effect of which is to vest the capital raised through issuance of those units or shares into unlisted private companies, provided that this is not done through a financial institution.

Chapter III - Chargeability, taxable amount and rates of common FTT

Commission Text	**EVCA Draft Amendment**
Article 9 *Application, structure and level of fees* 1. The participating Member States shall apply the rates of FTT in force at the time when the tax becomes chargeable. 2. The rates shall be fixed by each participating Member State as a percentage of the taxable amount. Those rates shall not be lower than: (a) 0.1% in respect of the financial transactions referred to in Article 6; (b) 0.01% in respect of financial transactions referred to in Article 7.	*Article 9* *Application, structure and level of fees* 1. The participating Member States shall apply the rates of FTT in force at the time when the tax becomes chargeable. ***Member States shall ensure that double taxation, where the established or issuing Member State charges the FTT in addition to the applicable tax(es) of counterparty non-participating Member States, is avoided.*** 2. The rates shall be fixed by each participating Member State as a percentage of the taxable amount. Those rates shall ***~~not~~*** be ***~~lower than~~***: (a) 0.1% in respect of the financial transactions referred to in Article

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3. The participating Member States shall apply the same rate to all financial transactions that fall under the same category pursuant to points (a) and (b) of paragraph 2.	6; (b) 0.01% in respect of financial transactions referred to in Article 7. *3.* The participating Member States shall apply the same rate to all financial transactions that fall under the same category pursuant to points (a) and (b) of paragraph 2. ***Notwithstanding this, Member States shall be entitled to derogate from the rates contained in paragraph 2 and apply lower rates for transactions which form an integral part of the process to grant equity and/or debt instruments as a means of financing to small and medium-sized enterprises within the meaning of Article 2(1) of the Annex to Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises.***

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About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About EVCA

The EVCA is the voice of European private equity.

Our membership covers the full range of private equity activity, from early-stage 345 capital to the largest private equity firms, investors such as pension funds, insurance companies, fund-of-funds and family offices and associate members from related professions. We represent 650 member firms and 500 affiliate members.

The EVCA shapes the future direction of the industry, while promoting it to stakeholders such as entrepreneurs, business owners and employee representatives.

We explain private equity to the public and help shape public policy, so that our members can conduct their business effectively.

The EVCA is responsible for the industry's professional standards, demanding accountability, good governance and transparency from our members and spreading best practice through our training courses.

We have the facts when it comes to European private equity, thanks to our trusted and authoritative research and analysis.

The EVCA has 25 dedicated staff working in Brussels to make sure that our industry is heard.