THE VOICE OF
PRIVATE CAPITAL
VENTURE CAPITAL
PRIVATE EQUITY
INFRASTRUCTURE
LONG TERM INVESTORS

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On behalf of the Public Affairs Executive (PAE) of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

Response to the Capital Markets Union Mid-term review 2017

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1. Fostering the financing of start-ups and non-listed companies

Are there additional actions that can contribute to fostering the financing for innovation, start-ups and non-listed companies? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

Note: The term “private equity” is used in this response to refer to all segments of the industry, including venture capital. “Venture capital” is used in specific contexts where there are issues that relate particularly to this segment.

Private equity funds provide long-term financing for more than 5,000 European businesses each year, 86% of whom are SMEs, employing around 8 million people. A stronger and more integrated European fund management industry is essential to increase funding opportunities for all companies that are in need of finance, whatever their size and maturity. It is not only start-ups that require capital - access to different sources of funding is relevant to companies at all stages to facilitate their growth and adaptation to a changing environment.

Venture capital

Initiatives already taken by the Commission, in particular the creation of the Pan-European venture capital Fund-of-Funds programme and the review of the EuVECA Regulation, are appropriate tools to increase the size of European venture capital funds – a precondition for attracting larger institutional investors into the European market - and allow managers to freely market their funds across EU borders. Fulfilling these objectives will foster the growth of the European venture capital industry and allow it to provide more funding to start-ups.

The success of the EuVECA review will depend on the agreement reached by the Council and the European Parliament. It is important to ensure that it contains the key elements of the Commission original proposal, in particular the extension of the scope to managers regulated under the AIFMD and the realistic eligibility criteria, while avoiding imposing on fund managers further requirements (such as excessive prudential capital) that would deter them from using the voluntary passport.

Meanwhile, the clarification that the EuVECA legislation creates both a marketing and **management passport** is in itself an important improvement to the EuVECA framework. A cross-border management passport would bring real added value as venture capital fund managers need the flexibility to be able to set up their fund in a country other than their home Member State. The final compromise should include the amendments suggested in that regard by the ECON Rapporteur in her draft Report.

Pre-IPO finance

A more vibrant private equity industry, beyond venture capital, is important for both investors into the asset class and for companies that are backed by private equity managers. This would provide a better choice and access to finance for non-listed companies at different stages of their life, as well as allowing large institutional investors to access a broader range of managers to achieve the strong, stable returns required to meet their long-term liabilities. Our experience suggests it is currently harder in Europe for an innovative company to find financing to scale up when it reaches a certain size, than to start its business. To achieve these objectives, fund managers need a regulatory environment that allows them to raise their funds across EU borders.

National private placement regimes (NPPRs) continue to play an important role in private equity fund marketing in Europe as they are – and will remain - sometimes the only option for sub-threshold managers to market their funds cross-border. Opting in to the full AIFMD regime is impossible for very many of those fund managers given the complexity and disproportionate costs it entails. While smaller managers could in principle market their funds under the EuVECA passporting regime, very often its eligibility criteria and investment requirements prevent funds that invest in companies at a later stage of their development from qualifying. Maintaining private placement is therefore critical.

In addition to the NPPRs, the Commission could also consider the development of a **voluntary passport for <u>all</u> AIFMD sub-threshold fund managers**, with regulatory obligations proportionate to their size (e.g. lower capital requirements, no depositary). Existing alongside the EuVECA and AIFMD regime, this passport would strengthen the private equity industry by ensuring every manager in Europe can potentially make use of a European passport without having to comply with a regime that is not suited to their (often small) size.

Finally, the success over the years of any European passport, whether AIFMD or EuVECA, very much depends on the ability of managers to use it without being subject to any restrictions and fees from host regulators that are not justified explicitly in the relevant piece of EU law or are not proportionate and discriminatory. **Any type of manager, irrespective of its size and characteristics,** should be able to market its fund cross-border and raise capital from a wide range of investors without undue administrative burden and effective barriers to entry. Therefore, amendments proposed to the EuVECA framework should be extended to AIFMD.

2. Making it easier for companies to enter and raise capital on public markets

Are there additional actions that can contribute to making it easier for companies to enter and raise capital on public markets? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

The effective functioning of the private equity model requires managers to be able to find proper exit options for their investments. Among the most important exit routes available to private equity is a listing on a public market. Ensuring that companies backed by private equity can easily enter public markets through IPOs would therefore both facilitate the development of private equity and increase more generally the role of capital markets in providing finance to European businesses. Strong capital markets have often been cited as one of the reasons for the difference in the success of venture capital markets in the US compared to Europe.

It was because of concerns about the long-term health of Europe's IPO markets that Invest Europe supported the IPO Task Force and contributed to its Report in 2015. While the new Prospectus Regulation takes into account some of the recommendations made in the Report to reduce the cost of listing, which remains the main barrier to increasing the amount of public offers in the European Union, we also invite the Commission to further consider its other ideas.

For example, and as indicated in the Report, promoting financial education for investors and companies that could be users of capital markets is worth further consideration. Early education and networking initiatives at the pre-IPO stage could prepare more companies to access capital markets and would ensure that exchanges play a stronger role in the future.

In many cases, the actions proposed within the Report will also mirror those suggested in other parts of this response, such as the recognition of the specific role of certain types of retail investors, or actions that could foster long-term illiquid investments, whether they take the form of tax incentives or a recalibration of risk charges currently imposed on banks when investing in certain asset classes.

3. Investing for long-term, infrastructure and sustainable investment

Are there additional actions that can contribute to fostering long-term, infrastructure and sustainable investment? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

Long-term investments are often deemed by regulators as inherently riskier and less suitable forms of investments than those that are liquid because they do not fit into the standard risk-analysis models which rely on the application of a daily "market value".

Solvency II

The intention to recalibrate risk-weights for private equity as part of the Solvency II review is an important step that may increase investment into long-term asset classes. While the 39% risk weighting for insurers' investments in certain types of private equity funds was a welcome improvement from EIOPA's original proposal, significant concerns remain that this still does not appropriately reflect the risk insurers face when investing in private equity and may act as a barrier to investing in these assets. The capital charge for private equity should be significantly lower than the existing 39% (or 49% in some cases). Analysis we conducted indicates that there is strong evidence that the capital charge for private equity in the standard formula should be in the range of 20% - 35%.

We also appreciate adjustments made to the Solvency II risk charges for infrastructure projects which can now benefit from a 30% risk-weight. However, we would like to reiterate that there is no reason, from an economic perspective, to differentiate between different types of infrastructure investments, and that investments into infrastructure corporates should not be treated as inherently riskier than those in infrastructure projects.

Operating entities are as essential to the provision of infrastructure as project entities and make equivalent contributions to the delivery of a service to end-users as investment in the construction of (new) physical assets. Without effective and efficient operation, an infrastructure asset may fail to deliver the economic benefits that it is designed to produce over the long term.

Brownfield and corporate transactions also play an important role in the ability of borrowers and credit institutions to recycle some of the capital otherwise committed to transactions currently already included in the definition of infrastructure. Their role is essential to the freeing up of capital required to finance new greenfield developments of the infrastructure of tomorrow.

Taking this into account, further amendments to the treatment of infrastructure corporates under Solvency II should avoid being overly restrictive and remain sufficiently broad to capture a wide range of corporate entities and not exclude any specific sector (for example, telecoms).

They should also address the fact that while indirect investments (e.g. via infrastructure funds) effectively have the same economic value as direct investments, in some cases they might have different characteristics and therefore some elements of the general framework, developed with direct investments in mind, may not be appropriate for them. Risk management or stress test rules should therefore not apply in the same way to them as to direct investments.

Banking

The recent proposal to revise CRR, where private equity and venture capital are no longer classified as items associated with "particularly high risk", represents a step in the right direction and might play a positive role in incentivising long-term investment. We also appreciate the Commission efforts to suggest a more favourable treatment of infrastructure as part of the CRR review. We think however that the proposed approach should cover both infrastructure projects and corporates for the reasons explained above.

The differentiation between infrastructure projects and other types of infrastructure investments can also be harmful in the context of the ECB guidance on leveraged transactions, as the ECB exempted infrastructure project loans from the scope of its guidance but failed to exclude other infrastructure investments such as infrastructure corporates.

Other examples

The Commission should be mindful that long-term investments are particularly affected by regulatory uncertainty. One concern is the fees and tariffs that infrastructure assets may attract, which have been subject to significant revision in the past, sometimes retroactively, eroding investors' confidence. To address these issues, the Commission could consider taking some actions to avoid the negative effects of retroactive rulemaking, either as a result of Member States' direct practices or state aid decisions, to allow infrastructure fund managers to operate in a more stable environment.

Finally, as indicated in our response to the Consultation on Long-Term and Sustainable Investment, the topic of responsible investment is of great significance to the private equity industry. We would also like to voice our support for the Commission's initiative to develop non-binding guidelines for reporting of non-financial information. This is consistent with our recommendations on ESG reporting contained in the Invest Europe Investor Reporting Guidelines.

4. Fostering retail investment and innovation

Are there additional actions that can contribute to fostering retail investment? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

Unlocking retail investment and putting retail savings to better use is an important aspect of the Capital Markets Union. But not all investment vehicles are necessarily appropriate for all retail investors. Due to the particular characteristics of a private equity investment, in particular its long-term and illiquid nature, typical retail investors do not usually invest into the asset class. When they do, this is done through listed vehicles or funds-of-funds rather than through direct investments. We believe this is appropriate and if the Commission is seeking to increase pure retail investment into the asset class, it should consider promoting these vehicles (for examples through tax incentives).

There is however an important distinction to be made between different types of 'retail' investor and between retail and professional investors. Those seen by the industry as a professional investor may not always meet the MiFID conditions for this designation. Much investment into private equity comes from high-net-worth individuals (HNWIs), such as family offices, entrepreneurs, wealthy individuals; or fund managers co-investing into the fund. While they clearly demonstrate a more acute knowledge of the industry they operate in than typical retail investors, and in all cases are well aware of the specificities of the private equity sector, they do not meet the criteria of “elective professional investors” drafted in a trading context. They would, for example, always fail the “frequency” criteria as it is not common practice for even the most sophisticated institutional investor in private equity to make more than a few commitments every year.

As a result, these investors are either not allowed in certain countries to invest into a private equity fund (unless it is an EuVECA); or are obliged to receive information (such as the KID) that is not always suited to their needs and level of understanding of the investment (the cost of which they will ultimately bear). This prevents sophisticated investors from accessing asset classes whose characteristics bear little resemblance to the markets for which the MiFID definition of professional investors was initially crafted.

This shortcoming is already taken into account in legislation such as EuVECA and Prospectus, which determine clearly that investors which have a better understanding of their investment than pure retail ones, should not be subject to all retail requirements. A recognition of these characteristics, either through an amendment of the MiFID definition of professional investors or by creating a new category of sophisticated retail investors in sectorial legislation such as AIFMD, would allow appropriate investors to have a better access to European markets without at all reducing investor protection. It would also provide far better access to funding for SMEs from a hitherto largely untapped source of capital.

If no such distinction is made, the private equity model could be harmed. For example, when addressing the issue of the level of fees for retail investors, the Commission should be mindful of the need to make a distinction between pure retail investment in, for example a UCITS fund, and, on the other hand, high net worth individuals committing capital to a private equity fund for around 10 years and able to negotiate with the manager the profit share they will offer. When proposing additional action on fees, the Commission will have to consider that the fee and remuneration structure in the private equity sector differs radically from other types of funds. The mixture of management fee and carried interest (which the manager generally only receives *after* investors have had returned to them their original investment and the share of profit that was negotiated and agreed in advance) is specific to this industry.

Another important element of the MiFID II framework is the uncertainty created by the ability of Member States to adopt specific criteria to determine whether local public authorities and municipalities can be deemed “professional upon request”. Given that entities such as local authorities in some countries invest in PE/VC funds, this will make it more difficult for AIFMs to market their funds cross-border in the EU, as they will first need to determine which rules apply before they can properly categorise their clients to market their funds to them.

In order to minimise the adverse effects of the changes to the client categorisation rules described above, and incentivise these authorities to invest in long-term asset classes, it would be worthwhile for a central register to be set up by the relevant European institution (for example, ESMA), setting out which client categorisation rules apply in each Member State in respect of local public authorities and municipalities.

5. Strengthening banking capacity to support the wider economy

Are there additional actions that can contribute to strengthening banking capacity to support the wider economy? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

Banks and capital markets must be seen as complementary sources of financing. Companies backed by a private equity fund will often also secure financing from third party banks as part of the overall financial package, for example to help with the investment in new capacity, to make add-on acquisitions, or to deal with short term financing requirements of the sort faced by all companies.

While taking new initiatives to develop a Capital Markets Union, the Commission should ensure that measures and initiatives taken by other European institutions do not undermine the CMU objectives. For example, the recent ECB draft guidance on leveraged transactions suggests that banks should automatically and in all circumstances treat loans to companies owned by private equity investors as leveraged, irrespective of the actual level of credit risk of these companies pose, the sector in which they operate or their debt/EBITDA ratio. If the ECB guidance were applied as proposed, far from strengthening bank investment into the wider economy, it would severely limit any type of bank financing for certain types of companies. Loans to such private equity backed companies are directly equivalent to bank lending to any other equivalent corporate with any other type of owner. Discouraging bank investment into a company solely because it is owned by a certain type of asset manager would not only go against the objectives of a Capital Markets Union, it would also ultimately deprive companies of multiple channels of finance.

While banks have a key role to play as providers of direct or indirect finance to companies backed by private equity, they act also as the first ‘touch point’ for many SMEs that have exhausted internal sources of funding (‘friends and family’) and are now looking to bring in external finance. Although some banks do refer SMEs whose credit applications have been rejected to alternative finance providers, there is no evidence that this happens systematically.

Banks should therefore commit to provide better information about alternative sources of finance and proactively take on a broader advisory role with businesses that approach them (and not only with those to whom they have declined to offer credit, which risks adverse selection). This is at least as important as encouraging the sharing of credit information with alternative providers of finance. Such initiatives should not need the support of EU policy and are capable of being entirely industry-led, but the support and encouragement of the European Commission would be welcome and such initiatives could usefully be integrated into efforts and platforms for SMEs such as the Enterprise Europe Network and the SME Internationalisation portal.

Banking regulation is also of relevance to the private equity industry because it defines the prudential treatment of investment firms. As the CRD/CRR current framework does not always appropriately address the specific risks of these investment firms' business models we support the principle of establishing a tailored prudential regime for investment firms. We would like to stress however that, while undertaking this review the Commission should recognise the specificities of the investment firms caught within its scope. If the regime is not calibrated correctly, it will lead to an increase in regulatory capital and therefore create barriers for operating in the market, both for existing smaller firms and new entrants alike. This is contrary to the aims of the Capital Markets Union and efforts to encourage investment in European businesses.

6. Facilitating cross-border investment

Are there additional actions that can contribute to facilitating cross-border investment? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

An appropriate marketing/management framework

As explained in our response to the section on start-up finance, strong national private placement regimes and proportionate (voluntary) passports are prerequisites to cross-border investment in the fund management space. Without the appropriate regulatory infrastructure, it will be much harder for institutional investors to access the best fund managers and sometimes impossible for small fund managers to access some of these investors. This creates a situation which ultimately leads to a reduced choice (and so increased risk) for investors and to a reduced amount of funding available for European companies that are large or innovative enough to operate on a European basis.

Divergence in supervisory practices create disincentives for managers to market their funds cross-border. Fees and charges imposed by host regulators and the introduction of other, regulatory, barriers such as requirements for local agents, also go against the spirit and the letter of single market legislation and impede the creation of a CMU, acting as a disincentive for managers to operate across EU borders. Their use should be limited and strictly monitored by the European regulator, and any requirement going beyond what is required from a supervision perspective should be seen as a barrier to cross-border operations.

The Commission could seek to address the different issues that affect the cross-border distribution of funds – from divergent views on the definition of marketing to the fees and charges imposed by Member States - from a horizontal perspective, warranting the creation of a truly European fund management industry. Our views on these specific barriers were expressed in detail in our response to the recent Consultation on the barriers to cross-border distribution of investment funds.

Third country access

So far the Capital Markets Union agenda has mostly centered on cross-border flows within the European Union. But free movement of capital on a global basis (both into and out of the EU) is also important both for portfolio companies based in Europe, which are the recipients of significant third country private equity investment, and for European institutional investors, who invest in third country private equity funds as part of their asset allocation and risk diversification strategies. Investment in EU companies by private equity fund managers whose office is based outside Europe has significantly increased over the last few years, demonstrating the global nature of these capital flows. Ensuring European investors have access to the best managers and European companies access to the broadest source of value-added capital is an essential component of a successful CMU.

In the meantime, and in light of the decision of the British people to leave the Union, the EU should also look at preserving its existing relationship with the UK market. An exit of the UK from the EU without the appropriate safeguards to prevent the erection of new barriers impeding existing flows could potentially severely limit the amount of financing for companies based on the continent.

Withholding tax

In some jurisdiction profits from the participation in a fund may be subject to a withholding tax. This withholding tax may be applied in advance of the redemption of shares/units in the fund or upon final payment depending on the legal status of the investor. The withholding tax may not apply on the profits received by certain categories of investors. In particular, the domestic legislation of Member States may provide for the exemption of the profit received by non-resident investors who either (i) are resident in a “qualified” country or (ii) are included in a “qualified” category. Tax authorities may have different views in identifying the nature of the non-resident investors. This results in lower returns for the investor and reduces the appetite of such investors to put their capital into similar investment opportunities in the future.

Financial stability: a balanced and tailored approach

Following the recent financial crisis, we recognise the relevance of developing a toolkit to assess and address issues related to financial stability. If and when taking further action in that regard, we would urge the European Commission and also other European authorities to be extremely mindful of the inappropriateness of simply expanding macro-prudential policy tools designed for banking into other parts of the financial services sector and of treating all non-bank entities in the same way.

While an appropriate supervision of the financial markets will help avoid repeating the crises of the past, regulators should be careful not to impose unnecessary requirements on entities, such as private equity firms, that can be clearly deemed non-systemic. Future rules, if adopted, will have to be sensitive enough to recognise differences between market sectors (and sometimes even within market sectors).

Contact

Thank you in advance for taking our feedback into account as part of the consultation process. We would be delighted to discuss any of the comments made in this paper in further detail.

For further information, please contact Christophe Verboomen (christophe.verboomen@investeurope.eu) at Invest Europe.

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 Invest Europe

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members' role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

For more information please visit www.investeurope.eu.