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VENTURE CAPITAL
PRIVATE EQUITY
INFRASTRUCTURE
LONG TERM INVESTORS

29 January 2016

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

Response to the European Commission Call for Evidence on EU Regulatory Framework for Financial Services

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

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Introduction

The Public Affairs Executive ('PAE') of the European Private Equity, Venture Capital and Infrastructure investment industry welcomes the opportunity to respond to the European Commission's Call for Evidence on the EU Regulatory Framework for Financial Services (the 'Call for Evidence').

We write on behalf of the representative national and supranational European private equity, venture capital and infrastructure bodies. 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 high-growth technology 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.

We welcome the opportunity provided by this Call for Evidence to assess the combined impact of legislation and the interactions between the different components of the existing rulebook. As we wrote in our response to the Capital Markets Union Green Paper, a top priority for the Commission is to ensure that the opportunities presented by the existing regulatory framework are being fully realised. While some additional, targeted legislative reviews - such as the review of the EuVECA Regulation - may well be necessary, there is significant scope to deliver meaningful benefits by better and more consistent application of existing legislation. Implementation and enforcement of the existing regime – much of which has been adopted with the intention of improving cross-border flows of capital - has the potential to make a significant contribution to growth in the EU.

In this contribution we provide the European Commission with 19 examples of issues that arise from the existing legislative framework for private equity, venture capital and infrastructure fundraising and investing.

"One size fits all"

Our first concern relates to the undifferentiated treatment of investment vehicles and investors. Over the past few years, EU law has often applied a "one-size-fits-all" approach to industries and financial market participants which have quite diverse business models and different risk characteristics.

In our examples, we show that it is crucial for EU law to distinguish between different categories of Alternative Investment Funds (AIFs) and types of investors (in particular between the retail, semi-professional and professional). Some progress has been made in this regard, such as the differentiated treatment of "closed-ended and non substantially leveraged funds" in Solvency II Delegated Acts or the creation of a category of "sophisticated investors" in EuVECA, and we believe that distinctions of this type should be applied more broadly. This will ensure that EU law establishes a regulatory and supervisory framework that is appropriately attuned to the nature and scale of the risk posed by particular activities and particular types of market participant.

While we understand the attraction of consistency across different pieces of legislation uniformity should not be pursued for its own sake. Where activities and / or market participants genuinely pose the same risk the same regulatory treatment is likely to be appropriate (unless there is an overriding, alternative public policy objective). But where this is not the case EU law should be appropriately nuanced.

Barriers to entry

The Capital Markets Union project provides an opportunity to tackle barriers to entry faced by those who want to invest across – and beyond- Europe. Invest Europe will respond to the proposed consultation on barriers to cross-border marketing of funds later this year – but in this Call for evidence we already provided examples of current rules which limit the ability of funds to fully exploit the opportunities of the Single Market. This is especially true for smaller fund managers for whom the AIFMD regime was accepted as disproportionate (hence the threshold) but who cannot market their funds under the parallel EuVECA passporting regime as their specific investment strategy – while still SME focussed - prevents them from qualifying; and for non-EU fund managers who want to access European institutional investors but are still obliged to operate under national private placement regimes, where they exist.

Private placement regimes should remain available to ensure investor and manager choice, but the diversity of conditions under which they operate and their unavailbility in a large number of cases act as serious limitations to the free movement of capital. And even where passports are available under AIFMD or EuVECA host authority fees, charges and other regulatory requirements impede access and thwart the single market intention.

Our response also contains several examples of overlapping and duplicative rules, which impact on the private equity industry at various points in the investment cycle, from fundraising through portfolio company investment to sale and exit. Such duplication often seems not to have any solid justification, and can lead to additional regulatory burdens for investors and act as a drag on their ability to invest.

Better Regulation

We fully support the new Commission in its Better Regulation agenda. In financial services detailed cost benefit analyses are required ahead of and throughout Level 1 and 2 law-making. Even if a reasonable effort is made to produce an initial cost benefit analysis on the Commission proposal this may be of limited relevance if the co-legislators make significant changes to the obligations being introduced, generating impacts that have never been assessed. Stakeholders must be given adequate time to respond to consultations, particularly where extensive effort will be required to procure impact data from those that will be impacted.

The Better Regulation agenda also needs to have a global dimension in recognition of the international nature of many financial services markets, including that for private equity. The implications for third country market participants and of the interaction between third country and EU rules have to be properly assessed. While the European Union has the right to set the standards and rules it feels are appropriate for those operating in its markets it also has a duty to take full account of the global nature of many of these markets and of the - equally legitimate- rules that other jurisdictions have put in place.

Regulatory stability

Regulatory stability is a key element for our industry. Private equity invests over the long term and regulatory change, whether at European or national level, impacts on both existing investments and on the willingness to make future investments.

This is particularly true for the infrastructure fund managers we represent. If Europe is to be an attractive destination for infrastructure investment, there needs to be a stable regulatory framework within which investors can operate and which allows infrastructure fund managers to invest over the long term without being discouraged by political and regulatory risk. In that regard, retroactive rulemaking is particularly harmful and risks fundamentally changingthe business case behind investments to which capital has already been committed.

The long-term horizons of private equity, venture capital and infrastructure investors mean they need some degree of comfort that the assumptions they make at the outset of an investment will remain largely true for years to come. Without this, investors cannot predict with enough certainty the costs and returns that are essential to developing a business case for investment. Uncertainty is inherent in making investments over the long term and if public policy such as regulation or tax adds additional unpredictability, this makes investment more difficult. One area of particular concern is the fees and tariffs that assets may attract, in particular in the infrastructure space, which have been subject to significant revision in the past, eroding investment returns and investor confidence in some European markets. While these barriers may not be under the responsibility of DG FISMA – or may even be the result of choices that sit with Member State authorities– we want to remind the Commission that these factors also play a role in investment choices made by fund managers.

We stand ready to provide whatever further contribution to this work the European Commission might find helpful, including attending meetings and contributing additional materials in writing, and look forward to the opportunity to play a constructive role in the development of a strong and growth-inducing Capital Markets Union.

Issue 1: Unnecessary regulatory constraints on financing

Example 1: State aid rules for venture capital

Relevant legislation:

Commission Regulation (EU) N°651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty ; Communication from the Commission — Guidelines on State aid to promote risk finance investments

Summary:

The existing General Block Exemption Regulation (GBER) allows certain categories of risk finance for SMEs in their early development stages to waive notification requirements provided specific conditions are met. GBER rules operate in tandem with the Guidelines on State Aid to promote risk finance investments. These provide details of how notification can be granted to certain categories of risk finance and measures that do not fulfill the GBER requirements.

Evidence:

State aid rules can have an important influence on the public funding received by venture capital funds. The vast majority of underlying portfolio companies that receive investment from venture capital are SMEs. For example, in 2014, 98.9% of underlying portfolio companies that received investment from venture capital were Small and Medium-Sized Enterprises (SMEs).

Governments play a major role in the provision of capital for early-stage investments. During the period from 2009 to 2014, 30% of the capital raised by venture capital funds was raised from government agencies. SMEs are often eligible for grants or other finance arrangements from public bodies and may also be in receipt of co-investment from venture capital. Ensuring that state aid rules do not threaten the ability of companies to obtain legitimate public support alongside financing from venture capital is therefore crucial for the overall functioning of the industry.

Under existing rules, when there is an element of state aid in a national scheme or specific national aid measure, the scheme or the measure must either be deemed authorised with reference to the General Block Exemption Regulation, or formally authorised with reference to the Risk Finance Guidelines following a notification to the European Commission.

The GBER provides that the total amount of risk finance that may be awarded to an eligible undertaking cannot exceed EUR 15 million, without any time limitation. In practice, this means that all aid granted via a risk finance measure under the GBER is counted towards this threshold over time, until the risk finance resources are used up. For innovative and potentially high growth start ups or SMEs (in particular in sectors such as life sciences) this limit may not be sufficient as a company may require more than EUR 15 million to enable it to grow to its full potential, and meet the broader policy objectives of overcoming market failures in SME finance, and encouraging SME job creation.

Another concern is the prohibition on certain types of investment activity. We note that this includes management buy-outs even though these often represent generational change by owner managers rather than disposals of businesses by larger parent companies. Business acquisitions by the SME are also impacted. There is a continuum of investment, from start up businesses to later stage companies. If at any stage, that continuum is broken, and a category of businesses do not get funding, then investor appetite will wither for earlier stage companies as well.

Implementation of the guidelines by Member States can also lead to some specific issues, such as those currently faced by Venture Capital Trusts (VCTs) and Enterprise Investment Scheme (EIS) in the United Kingdom. Both of those are tax-advantaged collective investment undertakings that facilitate the provision of equity capital to small, expanding companies.

Under the new UK rules, which are based on the Risk Finance Guidelines, VCTs will not be able to invest in a company after such company's 7th anniversary (10th anniversary for "knowledge based companies") of its first commercial sale unless either the company received its first state aid investment within said period after the first commercial sale or the amount of investment is more than 50% of the average turnover over the previous 5 years. This means that VCTs and EIS will not be able to make further investment in companies which they invested in prior to the introduction of the new rules unless they pass one of these tests, and will only be able to make this investment if they pass the turnover test.

Many venture capital funds have SMEs in their portfolio where the first risk capital investment was made more than 7 years after the company made its first commercial sale. Venture capital managers in general – and VCTs in particular - regularly need to make new investments into the companies they operate, in order to ensure their continued growth or even their survival. Current rules therefore have the potential to prevent further investment into companies for whom such injections can be essential to their survival.

Remedies:

Based on the evidence above, we suggest that the Commission re-assesses how the new Risk Finance Guidelines are preventing further investment into venture capital.

Given the long-term nature of venture capital investments, we would also suggest amending the period during which a maximum of EUR 15 million can be awarded to an eligible undertaking in the GBER. Resetting the limit set in Article 21(9) of the GBER after a suitable time (e.g.: three years) will allow further investments to be made in portfolio companies without generating any meaningful negative impacts on competition.

We are supportive of the market study proposed by the CMU Action Plan into the different tax incentives in place around Europe that support the growth of SMEs and address market failure.

Example 2: Solvency II – treatment of funds that are investing in long term illiquid assets

Relevant legislation: Solvency II Delegated Acts (risk-weights) - Article 1 of Commission Delegated Regulation 2015/35

Summary:

As part of the Capital Markets Union, the European Commission recently put forward an amendment to Solvency II delegated acts in order to reduce the capital risk-weights for infrastructure investments, and suggested that risk weights for private equity and venture capital investments would be revisited in a near future.

Evidence:

Long-term, illiquid assets are not well treated in prudential regulation. By their nature many long-term investments will not have a daily observable market price. Too often these characteristics are deemed by legislation to signify inherently higher risk than traditional liquid investments, simply because they do not fit into the standard risk-analysis models which rely on the application of a daily "market value".

We appreciate the Commission's willingness to reflect further on long term asset classes, on the real nature of the risks that they pose, and on the benefits that investors derive from them, especially those investors whose liabilities only mature in the long term like pension funds and life-insurance companies.

Infrastructure

Although Europe has a significant need for infrastructure financing, many sources of infrastructure investment have been in decline over recent years. Public sources of financing are constrained in many Member States and bank funding has become less available.

Infrastructure funds, with their finance and expertise in improving the operations of existing assets, are a part of the solution to European infrastructure financing needs. According to the latest Preqin survey, 65% of managers were planning to deploy more capital in the asset class in 2015 than they did in 2014. However, they can only help build Europe's future prosperity within a supportive regulatory environment.

But in order to do this the EU regulatory framework needs to be appropriate. Solvency II is a good example of how legislation that is not appropriately calibrated can act to impede investment. The definition of 'infrastructure' that will be used to determine whether an insurer should apply a lower risk weighting should be based on the nature and characteristics of the underlying investment and not on the specific corporate/legal form that asset takes.

An infrastructure fund's investment choice is based fundamentally on and determined by the nature, quality and characteristics of the underlying infrastructure asset rather than on the legal or corporate form that asset takes. As an example, an infrastructure fund may make investments into an electricity distribution business or into a natural gas transmission and distribution business supplying energy to a significant number of customers and end users. There is no reason that these investments should not be regarded as an 'infrastructure' investment, simply because the legal entity receiving the investment was structured in corporate form.

Private equity and venture capital

Throughout the discussions on Solvency II and in our response to the Green Paper on Capital Markets Union, we highlighted the unsuitability of using data derived from indices of listed equities (LPX 50 TR Index) as a proxy for measuring the long-term risk associated with investments in private equity.

Invest Europe – then EVCA- produced two detailed research papers on "Calibration of Risk and Correlation in Private Equity" (2012) and "Calibration of Risk and Correlation in Private Equity Based on the LPX 50 NAV Index" (2013). The first developed a new private equity index based on changes in the net asset value (NAV) of assets, adjusted by cash flows - by making this cash flow adjustment, the calibration incorporated a very important risk characteristic of private equity. The second paper sought to use other indices produced by the LPX group in order to satisfy the supervisory appetite for 'third party' data and for a 'market consistent approach' to be used to calculate risk weightings. Although some way short of what industry practitioners would regard as an appropriate measure, this work nevertheless provides a better proxy for the risk that insurers actually face than the LPX 50 TR used by EIOPA.

Both of the indices - LPX 50 NAV index and the LPX Direct NAV index – used in the October 2013 analysis display a number of benefits: i.e. they use daily available data; they are publicly available on Bloomberg; they are based on NAV developments of private equity investments; the index data can be used with the methodologies EIOPA already uses for other public market indices.

Remedies:

Infrastructure

We suggest that the definition of "infrastructure project entity" is amended so as to ensure that infrastructure corporates can be considered as qualifying infrastructure investments:

"55b. 'Infrastructure entity' means an entity ***or corporate group whose primary function (including via a concession) is*** *owning, financing, developing or operating infrastructure assets, where the primary source of payments to debt providers and equity investors is the income generated by the* ***infrastructure*** *assets."*

Private equity and venture capital

Meanwhile, we stand ready to help the Commission in calibrating appropriate risk-weights for private equity and venture capital investments ahead of the proposed review in 2018. We believe that even within the constraints of using a (fundamentally inappropriate) 'market-based' approach, there are other indices that provide a much more accurate proxy for the risk that insurers actually face. All of these generate a standard formula for risk weights lower than 39% - and closer to the 20% - 35% range. We are keen to work with the Commission and EIOPA to develop a more suitable methodology in the future.

Example 3: Banking Structure – exemption for non-substantially leveraged AIFs

Relevant legislation: Regulation on structural measures improving the resilience of EU credit institutions, (currently discussed in Council and Parliament). While we recognise the intent of this Call for Evidence is not to comment on issues currently under discussion, it is a good example of misconceptions around the relationship between banks and investment funds.

Summary: Article 6 of the Commission proposal states that private equity funds are exempted from the ban on proprietary trading provided that they are closed-ended and unleveraged. Though welcome this exemption does not take account of those closed-ended AIFs, which have an equally important and beneficial role for the real economy but deploy a limited, non-substantial, amount of leverage.

Evidence:

It is important to stress that 'leverage' for this purpose is a defined term – a technical measure of exposures – and that the concept does not have its ordinary commercial meaning. As an example, the use of derivatives to hedge currency exposures could result in an AIF being considered 'leveraged', even though no investor into a fund that was using derivatives for such risk management purposes would ever see this as a leveraged entity.

Although they are typically not leveraged, private equity funds may incur bridge finance at the fund level and may enter into currency hedges. These facilities are used for specific purposes and are usually backed by the undrawn contractual capital commitments of investors. For example, in order to close an investment or provide emergency finance to an existing investment the bridge facility may be utilised. This is then repaid within a short timeframe by funds drawdown from investors.

In some cases these types of facilities (which are used in private equity and venture capital funds to manage the cash flows between the fund and its investors and were introduced for the benefit of investors to enable them to retain their undrawn cash for as long as possible until it is needed for a specific investment) may be considered as leverage and therefore prevent some private equity funds from benefitting from the exemption in Article 6(3) of the Banking Structure proposal. A binary distinction between "leveraged" and "non-leveraged" funds is not appropriate and such a stark division may exclude from the exemption private equity funds who are investing in the real economy and do not pose any systemic risk given the small amounts of leverage that they are using.

These arguments alone are sufficient to justify moving away from a binary approach that treats any amount of leverage as inherently risky. More generally it should be recognised that appropriate amounts of leverage, managed prudently and with appropriate oversight from financial market and macro-prudential supervisors can play an important role in maximising the finance available to those businesses that need it without endangering financial stability.

This is why we believe the Commission should take inspiration from the concept of "substantial leverage" as already defined in the AIFMD framework (cf. Article 111 of Delegated Regulation 231/2013). The AIFM Directive also provides tools for monitoring and addressing any potential systemic risk that could arise from any fund leverage. Where the stability and integrity of the financial system may be threatened, the competent authorities already have the power to impose limits on the level of leverage. This solution provides supervisors with a robust tool to intervene if fund leverage threatens financial stability.

Remedies:

The exemption for private equity AIFs should be built on the distinction between AIFs that are substantially leveraged and those that are not, based on Article 111 of Commission Delegated Regulation (EU) No 231/2013.

Issue 3: Investor and consumer protection

Example 1: Shareholders' Rights

Relevant legislation:

Shareholders' Rights Directive, Article 3f, g and h (Chapter Ib), as proposed by the European Commission.

The concerns expressed below apply to the Council general approach and to the text adopted at first reading by the European Parliament, both of which follow the broad lines of the Commission proposal. While not directly under the remit of DG FISMA, the proposal has direct implications on fund managers.

Summary:

Despite the fact that private equity fund managers invest by their very nature over the long-term into private companies, they are within the potential scope of the Shareholders' Rights Directive as they meet the "asset manager" definition under Article 2, and may, in certain circumstances, hold shares in listed companies.

Evidence:

A privately-held company that has been backed by a private equity firm may reach a stage of growth and development at which it makes sense to raise further capital for future expansion/growth via an Initial Public Offering (IPO). As a sign of its commitment to, and confidence in, a company that it has already backed for many years (on average around 6 years) the fund manager will usually commit to retaining some shares once the company has listed.

Such a strategy signals to other investors the private equity fund manager's belief that the company will continue to enjoy success over the long term. Keeping shares of the company is therefore just one further component of an inherently long-term strategy adopted by the fund manager. In the Impact Assessment accompanying the proposal, the Commission in fact recognizes the role private equity plays in providing long-term investment by referencing Invest Europe (then EVCA) as a source of good practice when it comes to the benefits of long-term funding of European businesses[1].

More importantly, and as demonstrated above, private equity fund managers will continue to own listed shares of a company which has IPOd in order to continue to demonstrate its support for the further growth of the company in the first years of its life as a quoted entity. Imposing further regulatory burdens on private equity fund managers beyond the requirements of their sectoral legislation risks creating a dis-incentive them to remain investors in these companies when they are listed. In this case the proposed rules would not only fail to achieve the objective of improving investor protection, but also make long term commitment to companies *less* appealing.

Remedies:

One simple solution would be to adapt the definition of "asset manager" to exclude private equity funds from the scope of the Directive, recognizing that, within their business model, keeping shares of a company they invested in post the IPO is *de facto* the result of a long-term policy.

This could be done by excluding from the Directive any manager of an AIF that is closed ended and not substantially leveraged. This approach would follow the thrust of the existing legislative framework. Recent proposals in the field of financial services – such as the Banking Structure Regulation and the Solvency II Delegated Acts - now include wording designed to differentiate private equity funds from other AIFs.

Example 2: Exemption of pure retail type of disclosure for sophisticated investors

Relevant legislation: KID-PRIIPS Regulation, scope and Art 8; Prospectus Regulation/Directive

Summary:

[1] Shareholders' Rights Directive II, Impact Assessment,(SWD 2014 127 final, p.40)

Whilst it is necessary to provide the appropriate level of transparency to retail investors, we are concerned that the current KID-PRIIPs and Prospectus Regulations make no reference to semi-professional investors, such as those described as “sophisticated” in Article 6.1 of EuVECA.

We believe the absence of a distinction between retail and semi-professional investors will require fund managers to produce unnecessary disclosure documents for certain types of investors who already have a very good understanding of the venture capital market and have been recognized as key investors in therelevant sectoral legislation (i.e. EuVECA). Exempting these investors from the requirements specific to retail customers will have no detrimental impact on investor protection and consumer confidence overall.

Evidence:

As demonstrated in our Example 2 in Issue 11, there are a number of “sophisticated” investors in private equity and venture capital who, although experts in their field, will not meet the requirements to be considered as a professional investor. We have welcomed the recognition in EuVECA that not all so-called retail investors are alike and that the binary distinction set within MiFID might impose unnecessary compliance costs in some cases.

As stressed in our response to the EuVECA consultation, the recognition that high net worth individuals or family offices – a crucial part of the venture capital investor base - are different from the average retail investor adds a welcome level of granularity and makes it easier for venture capital and private equity funds to approach and attract these investors.

KID for sophisticated investors

All prospective investors in a private equity fund, including semi-professionals, are provided with extensive information on the fund and the fund manager and carry out their own due diligence prior to making an investment. The fund documents will contain, among other items, information on the investment strategy (investment scope and policy), the team that will execute it, the structure of powers, financial terms, reporting, a summary of the risk factors and tax considerations. In addition, as part of their investment, investors will need to acknowledge that they understand the risks involved in making that investment.

While producing a KID may be of use for average retail investors with little understanding of their investment, and may have the effect of encouraging investment in certain asset classes, it is unlikely that a KID will make private equity and venture capital funds more attractive to sophisticated investors. These investors most often require particular information specific to their needs and are unlikely to find the simplified information contained in the KID to be of any use.

Although drawing up a KID will not necessarily require a considerable amount of work for the fund manager, given the amount of time already spent on fund documents, drafting such a document for investors who do not require it will nonetheless add to the burden of compliance without generating any appreciable benefit.

It is interesting to note in that context that EU legislation is more stringent than national legislation in Member States where these specific funds exist. In France, where funds such as “fonds d’investissement de proximité ('FIP')” have, since 2001, been required to prepare a presentation of risks, costs and performance scenarios for retail funds, these requirements do not apply to funds that only market to semi-professional investors.

KID for carried interest and co-investment vehicles

From a more technical perspective, it is important to confirm in further guidelines that carried interest and co-investment vehicles should not be regarded as PRIIPs because they are not vehicles which are "manufactured" by an entity in the financial services industry to provide investment opportunities to retail investors. They are rather a mechanism designed to facilitate the alignment of interests with those of the investors. As such, the vehicles are not, "manufactured by the financial services industry to provide investment opportunities to retail investors" (Recital 6, PRIIPs Regulation). In addition, such vehicles do not involve any “packaging” element but are rather vehicles through which a direct holding in either the portfolio company structure or the fund itself is held.

Prospectus

Both the existing and the recently published Prospectus Regulation/Directive allow issuers who are only marketing to qualified investors to be exempted from the obligation to draw up a Prospectus. As explained earlier, and given their natural understanding of investments into private equity, we believe issuing securities to semi-professional investors should systematically not give rise to the creation of Prospectus, providing it is clear these investors are aware of the risks associated with such issuance.

Remedies:

For the reasons outlined above, there are compelling reasons for developing an additional category of investor, comprising those not deemed professional under Annex II of MIFID but whose level of understanding and sophistication makes it inappropriate for them to be considered as average retail investors. This category could include all investors satisfying the test set in Article 6.2 of the EuVECA Regulation. Marketing only to these investors should not trigger the requirements set in the KID-PRIIPS and Prospectus Regulation.

As set out in the existing EuVECA test, prior knowledge of the type of investment and a threshold for the amount invested would be criteria to determine these investors.

In relation to carried interest and co-investment arrangements, it should be expressly acknowledged that these vehicles are not PRIIPs and therefore no KID needs to be prepared in these circumstances.

Issue 4: Proportionality / preserving diversity in the EU financial sector

Example 1: Cross-border marketing of AIFs

Relevant legislation: Alternative Investment Fund Managers Directive (AIFMD), EuVECA

Summary:

European institutional investors need to be able to access the best investment opportunities, within Europe and globally. This helps them both to achieve returns and manage risk by diversifying their portfolio across geographical borders. As intermediaries between these large funds and the often small companies which require financing, private equity fund managers play a key role in providing these investors with diversified investment opportunities.

While the AIFM Directive already allows some private equity funds managers to market their funds to these institutional investors within Europe borders, through the use of a passport, some fund managers do not benefit from such an access:

1. EU AIF managers with assets below EUR 500 million (so called "sub-threshold fund managers") are not able to market cross-border unless they either opt-in to the (by definition) disproportionate AIFMD regime or can qualify for the EuVECA regime (which has strict eligibility criteria);

2. Non-EU AIF managers are further restricted in their ability to access European institutional investors (and vice versa) owing to the restrictive features of some NPPRs and the unavailability to date of a passport. The conditions that will apply to any such passport should it be granted are also likely to make it an unappealing option for many managers.

Evidence:

Private equity and infrastructure funds are an essential – and growing - part of the institutional investors' portfolios, generating returns by giving them access to a broad span of investments, from start-ups with high potential to long-term infrastructure assets. Many of these fund managers will be located in the EU, but EU based institutional investors also want to be able to access the best managers, wherever they might be located in the world.

1. *Access to sub-threshold funds*

Invest Europe's members support the distinction between above and sub-thresholds funds, which recognises that for fund managers with assets below EUR 500 million the costs associated with application of the AIFMD would simply not be sustainable. But too many smaller fund managers are now prevented from operating across the EU single market either because Member States are excluding them from their national private placement regime or because they do not qualify for the EuVECA passporting regime given the strict eligibility criteria for that regime (which limit its availability to certain venture capital funds and excluding, for example, growth capital funds).

A situation in which many managers of growth funds - providing capital to European SMEs - are unable to undertake cross-border marketing unless they opt in to a regime designed for large fund managers and manifestly unsuited to them, seems difficult to justify in a Capital Markets Union and may even run counter to Treaty freedoms. According to our 2014 statistics, there are 510 companies in Europe with assets under management between EUR 100 and 500 million. They have a total of EUR 11.2 billion assets under management, representing more than a quarter of all private equity and venture capital firms in Europe and more than a fifth of assets under management. Such managers should as a minimum be able to market cross-border under national private placement regimes on the same basis as domestic managers. But the Commission's level of ambition should extend further and an appropriately tailored pan-European regime – similar to EuVECA – should also be introduced.

This can have a direct positive effect on the financing of companies across Europe. In 2014 growth fund managers only raised €1.8 billion in Europe compared to the €4 billion of capital raised by venture fund managers. In the same year, 3380 companies received venture capital investment while only 1292 were backed by growth capital. Growth and other sub-threshold funds have the potential to make a valuable contribution to the funding of SMEs that are looking to expand and develop, but their ability to do so is being hampered by the restrictions being placed on their ability to market across EU borders.

2. *Access to non-EU fund managers*

European investors want to be able to access opportunities in other parts of the world. European pension funds and insurance companies, which manage more than €12 trillion of assets, need to be able to diversify their portfolios for prudent risk management purposes. They also need to achieve returns, not least to deliver to European citizens the growth in their pensions and savings that they expect. To meet these expectations institutional investors need to be able to access fund managers and markets across the world.

As we explained in our response to the Capital Markets Union Green Paper, capital invested by European institutional investors into non-European private equity fund managers has every chance to be reinvested into European companies, provided these are attractive. Between 2010 and 2014, private equity firms located outside Europe invested EUR 6bn in the European economy; over the same period of time, private equity firms located in Europe invested EUR 12.4bn in non-European economies. Similarly, over the last 5 years the investment of non-European private equity fund managers into European companies has grown significantly both in nominal and percentage terms (from 2.4% to 10.8% of overall investment for venture capital).

Remedies:

It is vitally important for institutional investors such as pension funds or insurance companies to have access to investment opportunities offered by sub-threshold and non-EEA fund managers.

1. *Access to EU sub-threshold fund managers*

Allowing more growth, development and later-stage fund managers to be able to use a better tailored regime similar to the voluntary EuVECA regime in order for these funds to be able to market more efficiently cross-border would help growth funds to support more companies with later stage financing. More details on this can be found in our response to the EuVECA consultation.

2. *Access to non-EU fund managers*

We believe that the AIFMD third country passport should be introduced for key jurisdictions as soon as possible as a regime sitting alongside national private placement regimes. This combination of marketing routes is necessary to ensure that European investors enjoy access to non-EU fund managers.

Example 2: ELTIF diversification rules

Relevant legislation: European Long-term Investment Fund (ELTIF) Regulation

Summary:

The ELTIF eligibility criteria risk creating difficulties for fund managers interested in using the new category.

Evidence:

AIFs long-term characteristics that are very similar to those of an ELTIF are not included as eligible investments in the Regulation. With investments holdings of more than 5 years on average, private equity is an asset class with a proven track record in long-term investment. The Commission has recognised this positive role on many occasions[2]. For this reason, private equity AIFs would be a legitimate and appropriate investment for an ELTIF, consistent with the goal of promoting long term financing into unlisted assets and their exclusion should be revisited.

Remedies:

In order to fully unlock the potential benefits of diversification, we believe that the ELTIF should include AIFs with long-term characteristics as eligible investments. This distinction can be made by allowing ELTIFs to invest into closed-ended and non-substantially leveraged funds.

If that is not possible, we would suggest setting a higher limit to sufficiently diversify into other funds. Increasing the limit on investing in other funds (EuVECAs, EuSEFs and other ELTIFs) from 20% to 30% in Article 12 would provide, in our view, further diversification options.

This would also result in more opportunities to provide returns to investors during the life of the fund as the ELTIF will be invested in more diversified and numerous underlying assets.

Example 3: Specific treatment of closed-ended and non-substantially leveraged funds

Relevant legislation: AIFMD, Art 4.1a as well as: Banking Structure; Solvency II; ELTIF

Summary:

The definition of an AIF set out in the AIFMD covers a very broad range of funds that have different structures, business models and risk profiles. Such a broad definition may be inappropriate when it is cross-referenced in other legislation.

Evidence:

The current AIF definition encompasses funds with very diverse structures and investment strategies, and captures everything from a highly leveraged hedge fund taking short positions in listed equities, through to infrastructure funds investing in tangible energy or transport assets. Private equity and venture capital funds providing equity for the long term to businesses, many of which are small and medium-sized enterprises (SMEs), also fall under the existing AIF definition. Indeed as Article 4(1)(a) of the AIFMD makes clear, often the only characteristic that AIFs share is that they are not UCITS funds.

We believe that this grouping together of funds does not take account of the defining characteristics of private equity.

- Private equity is a **long-term investment approach,** which takes time to mature.

Fund structures in private equity have been specifically designed to reflect this long-term characteristic. Investors participate by making a legally binding commitment to invest a specified amount of capital in

[2] SWD 2014 127 final, p.40

the fund, entitling them to a proportional share of fund interests. Funds are usually structured as closed-end vehicles with a minimum life-span of 10 years, to ensure that the underlying companies in which investments are made have the time and potential to grow and develop further.

- PE funds are **not designed to be traded like a liquid asset**, or for investors to be able to redeem their investment during the life of the fund.

Indeed, this is typically expressly excluded by the legal agreement, which governs the management of the fund. Although a secondary market can exist, the terms under which an investor can sell their position on the secondary market to another investor are limited and strictly governed by the terms of the fund's legal agreement. The Invest Europe (then EVCA) risk measurement guidelines cover this topic in more detail[3].

- The fund manager draws down from this capital pool of commitments to fund the equity investment (often a controlling investment) in a **diverse range of portfolio companies** over the course of the fund's investment period (typically 5-6 years of the fund's life).

As the fund realizes its investment in each portfolio company the proceeds are promptly distributed to the investors.

- The fund manager seeks to increase the value of the portfolio companies through **long-term active ownership**.

Active ownership in the context of a private equity fund's investment typically means being active members of the board of the company and working with the management team, also outside the formal board meeting cycle through committees, on a variety of operational aspects of the business as decided by the board. This includes contributing to the development and implementation of the business strategy, recruitment of key members of the management team and helping management build a sustainable business beyond the period in which the private equity fund is invested.

- As funds typically start making distributions to investors before having drawn down and invested the entire commitment, the **capital at risk** is invariably much lower, on average, than the investor's overall legal commitment to the fund.

An investor's average net invested capital (or capital at risk) is measured by the paid-in amount minus distributed capital. In addition, proceeds from realizations can be used to fund that part of the investor's commitment still to be drawn down.

- Private equity funds typically **do not employ leverage at the level of the fund**

They are legally structured to prevent exposure for the fund itself. Borrowing is typically contractually restricted at the fund level. As explained in our response in Example 3 of Issue 1, a private equity fund is, however, generally permitted to borrow on a short term basis for the very specific purpose of efficient cash flow management, i.e. to bridge the period from when an investment is made by the fund to when money is received from investors following the issue of a draw down notice, requiring investors to pay over a portion of their capital committed to the fund. Amounts borrowed at the fund level for these purposes are typically capped and secured for their duration against the undrawn (but legally binding)

[3] http://www.investeurope.eu/media/10083/EVCA-Risk-Measurement-Guidelines-January-2013.pdf

commitments of investors, and therefore do not increase the aggregate amount available for investments at fund level.

- The private equity model also protects against **systemic risk** by ensuring that no portfolio company bears any risk as a result of the debt of other portfolio companies that have been backed by the same fund and/or manager.

Moreover, private equity funds do not face the risk of "runs" because their investments are fully backed by equity commitments from their investors, which are predominantly institutional such as pension funds and insurance companies, and are structured as closed-end funds to which investors are committed throughout the life of the fund, with no discretionary right of redemption.

Remedies:

EU law has gradually recognised the heterogeneity of AIFs in recent measures and the contribution that some such funds play to European businesses.

Although the Commission took this new approach in specific pieces of law, such as the Delegated Regulation on Solvency II, all AIFs are still lumped together under the same umbrella in most of the EU rulebook, despite significant differences between them.

Example 4: AIFMD – remuneration: suggested new approach to the proportionality principle

Relevant legislation: AIFMD Remuneration Guidelines; EBA Guidelines on sound remuneration policies under CRD IV; ESMA Consultation Paper "Guidelines on sound remuneration policies"

Summary:

Remuneration rules in AIFMD have, in many cases, been directly copied and pasted from those drafted in CRD III. This "one-size-fits-all" approach failed to recognise that private equity incentives schemes, which are now regulated under the AIFMD, differ significantly from the banking ones. In particular, carried interest, which is partly included in the remuneration definition for regulatory purposes, is essentially a share of the fund's realized profit and has the primary objective of aligning the interest of institutional investors and fund managers .

Given this, proportionality rules, which allow fund managers to comply with the principles "in a way and to the extent that is appropriate to the AIFM's size, internal organization and the nature, scope and complexity of the AIFM's activities", are crucial to avoid imposing unsuitable rules on a whole industry.

In this context, we would like to make the Commission aware that, if the supervisory authorities were to reverse the approach to proportionality set out in the existing AIFMD Remuneration Guidelines, this could potentially render unworkable a model that meets the policy objectives set down at EU level and that has consistently delivered alignment of interests for investors. Given the objective of carried interest is to align incentives of the fund managers with its investors, imposing a new interpretation of the proportionality principle across all types of AIF will not generate any additional benefit for PE investors.

Evidence:

Private equity carried interest and co-investment arrangements feature inherent long-term deferral and risk-adjustment characteristics. In addition distributions (i.e. the payments made as a result of these arrangements) are based only on realised (not accounting) profits. These arrangements align interests and provide a variable long-term incentive to executives / "identified staff" of the fund manager. For this reason, they do not have the flaws and associated risks that have been identified in certain arrangements in other parts of the financial sector, where bonuses may, for example, be based on accounting profits (as opposed to realised cash profits) and fail to take account of the long-term impact of actions or omissions.

EU remuneration rules, developed through CRD III, AIFMD, CRD IV and UCITS V have attempted to address those failings. However, these rules are designed for structures that differ radically from those that are the norm in private equity. Provisions in these legislative acts regarding deferral, payment in units and risk adjustment may be appropriate and necessary in many parts of the financial sector but pose a fundamental challenge to one of the core features of private equity, where the current arrangements already achieve what is being intended as explained above.

To be forced to apply those rules without the proportionality principle would in most cases be practically unworkable. This would serve to reduce the alignment of interests between investors and fund managers and could lead to perverse outcomes, which would not serve investors' interests and indeed may be regarded by investors as a retrograde step in protecting them. For more details on this, we refer the Commission to sections II and III of our detailed response to Question 1 of the ESMA Consultation Paper "Guidelines on sound remuneration policies". (http://www.investeurope.eu/media/420568/ESMA_UCITS_V_AIFMD_REMUNERATION_Invest-Europe_RESPONSE_231015.pdf)

Importantly, proportionality as adopted by ESMA in the current AIFMD Remuneration Guidelines does not allow for a general disapplication or a general waiver from the remuneration rules. Neutralisation is never automatically triggered on the basis of the Guidelines alone. AIFMs are always required to perform an assessment for each of the remuneration requirements and determine whether in their particular case and circumstances it would be proportionate to apply it wholly, in part, or, in some cases, to apply full neutralisation. The ways in which AIFMs implement the proportionality principle are also reviewed and overseen by their national competent authorities.

Remedies:

Based on the evidence above, we strongly caution against any change to the use of the proportionality principle for private equity firms. In that regard, we fully support the approach of the application of this principle proposed in the ESMA Consultation Paper and to not extend proposed changes in CRD IV to AIFMD remuneration guidelines.

Issue 6: Reporting and disclosure obligations

Example 1: AIFMD: periodic regulatory reports set in Annex IV

Relevant legislation: Alternative Investment Fund Managers Directive (AIFMD), Article 42 and Annex IV

Summary: When marketing units or shares in a "host" Member State without a passport, a non-EU AIFM must submit a notification to the competent authorities of its "home" Member State, including documentation and information detailed in Annex IV of AIFMD. Divergent national approaches to reporting (e.g. different reporting interfaces and technical structures) imply that non-EU fund managers are diverted from the core business, with no obvious benefit to financial stability or investor protection.

Evidence:

AIFMs seeking to use national private placement regimes under Article 42 of AIMFD are currently faced with the absence of a harmonised 'registration process' across the EU and the varying conditions which must be met to satisfy different national private placement regimes. This means that AIFMs incur considerable costs in relation to any non-EU fund which is to be marketed across the EU as legal and other advice must be taken in each relevant jurisdiction and administrative charges are incurred on a per-jurisdiction basis. *De facto* barriers to entry to other EU markets are in place.

Streamlining the notification process and subsequent periodic reporting requirements would help to reduce costs. At the moment, different forms are used for filing by different Member State regulators. There are also differences between:

- the supporting information which must be supplied with the form,
- the way in which the form must be filed,
- the fees which must be paid
- the time period for the regulator to consider the application and the form/material submitted

Remedies: We believe that AIFMs should only report once to a single authority (e.g. through ESMA), which could then share such information with Member State regulators as deemed necessary. This would greatly reduce costs and complexity for non-EU fund managers.

Issue 9: Barriers to entry

Example 1: Fees and charges

Relevant legislation: Alternative Investment Fund Managers Directive (AIFMD), Art 32; EuVECA, Art 1

Summary:

Some 'host' Member States are imposing additional fees and charges and/or additional requirements on EU fund managers looking to use their single market passport to market in that jurisdiction. This is the case both for passports provided under AIFMD and EuVECA.

Additional constraints include the requirement in Germany to prepare a local addendum to the mandatory pre-investment transparency disclosures made under Article 23 AIFMD, even when the content of those disclosures has been approved by the AIFM's home state regulator.

Evidence:

Where an AIFM has been granted a marketing passport by its home Member State regulator there is no legal justification under the AIFMD for any additional restrictions and/or requirements to be imposed on the AIFM by the host Member State regulator. These additional costs are an impediment to cross-border marketing and are already causing some fund managers not to market in certain jurisdictions – thus, removing additional requirements could bring immediate advantages.

At least 11 Member States are imposing additional fees and charges on AIFMD-registered EU fund managers not based in their country, thereby reducing access to market in a significant part of Europe, including in larger markets such as Germany, France, Spain and Italy.

Please see our response to the EuVECA consultation for more details on the fees imposed in the specific context of this legislation.

Remedies:

The AIFMD clearly states that it aims to establish an "internal market for AIFMs and a harmonised stringent regulatory and supervisory framework for the activities within the Union of all AIFMs". We therefore urge the European Commission and the European supervisory Authority (ESMA) to take action against these practices and we continue to stand at disposal to inform them on the different cases across Europe, also in the context of the upcoming consultation on barriers to cross-border investments.

Example 2: Full authorization under AIFMD to become ELTIF

Relevant legislation: European Long-term Investment Fund (ELTIF) Regulation

Summary: We feel the barriers to entry for prospective fund managers seeking access to the ELTIF regime are too high. Requiring full authorisation under the AIFMD, as well as additional restrictions on eligible investments, is not conducive to its uptake.

Evidence:

Experience at Member State level suggests that an "AIFMD-plus" approach is not conducive to attracting significant take-up of new vehicles. For example, the loan-originating Qualifying Investor AIF ("QIAIF") designation introduced by the Central Bank of Ireland in October 2014 requires full AIFMD compliance, adherence to a 1:1 exposure limit on assets versus liabilities along with a retention or "skin in the game" rule as mandated under the EU Capital Requirements Regulation. This regime has generated very little interest to date.

Remedies:

Alternative entry routes for prospective ELTIF managers should be considered for the future. This could take the form of "EuVECA plus depositary" approach (where accessing retail investors), or developing a mechanism for registered sub-threshold AIFMs to make an ELTIF application. The success enjoyed in the UCITS space can be replicated for alternatives if the regulatory requirements are proportionate.

As the explanatory memorandum to the Commission ELTIF Proposal states, "[t]he creation of the European Venture Capital Funds (EuVECA) and the European Social Entrepreneurship Funds (EuSEF) will, alongside the ELTIFs, help to contribute to the financing of the European economy.[4]" This alignment between the ELTIF and EuVECA frameworks should be further developed, in light of the similarities between the two, i.e. focus on long-term, unlisted assets. The ELTIF Regulation would benefit from allowing managers of EuVECAs, as well as Alternative Investment Fund Managers, to become managers of ELTIFs. Allowing two

[4] European Commission Proposal for a Regulation on European Long-term Investment Funds, 26 June 2013, page 3

routes to become an ELTIF Manager would widen the pool of investors interested in investing into long-term assets and allow smaller funds who are outside the scope of the AIFMD, but still regulated at EU level, to offer this product. Furthermore, it would promote diversity in ELTIFs as there will be a broader range of ELTIF Managers which will add to choice and competition. This is especially relevant since listed SMEs as well as unlisted SMEs are included as eligible undertakings.

Issue 11: Definitions

Example 1: Clarity around the definition of SMEs and the concept of "linked enterprises"

Relevant legislation: European Commission Recommendation 2003/361/EC; AIFM Directive; EUVECA Regulation.

Summary:

The definition of SME set in European Commission Recommendation 2003/361/EC is of particular importance for the private equity and venture capital industry.

The SME definition, designed for a specific state aid purpose, is widely (and increasingly) cross-referenced in several pieces of EU legislation. The AIFM Directive, for example, provides an exemption for SMEs from certain requirements in the field of disclosure and asset stripping, investing into SMEs is one of the qualifying requirements to become a EuVECA registered fund, and fulfilling the conditions of the definition is a prerequisite to become eligible for support under specific EU programmes.

Evidence:

It is important to stress that private equity and venture capital fund managers invest mostly in SMEs. In 2014, 86.3% of the companies private equity AIFs invested in had less than 250 employees. This number rises to 98.9% when it comes to venture capital.

The EU SME definition set in Recommendation 2003/361/EC includes the concept of "linked enterprises". Under the linked enterprise rule, companies that receive a majority/controlling investment from a private equity or venture capital firm are very likely to lose their SME status. This will have direct consequences for the SME and the private equity fund, including the prohibition for these companies from receiving aid in the form of grants/tax breaks where SME status is a condition.

As an example, the current SME definition creates significant barriers to corporate venture capital investment. In the present regime, start-ups that have received between 25% and 50% of their risk capital in the form of corporate venture capital investment will not anymore be considered as SMEs. This distinction between types of venture investment is not justified in practice and makes it more difficult for corporate investors to provide much needed early-stage financing to these companies.

Remedies:

Invest Europe (then EVCA) was in touch with the European Commission to ensure the concept of "linked enterprises" would not be part of the AIFMD cross-reference to the Recommendation. Invest Europe received clear confirmation from the Commission that the concept of "linked enterprises" does not apply.

In that context, we would favour the wording of the Prospectus Regulation, which describes SMEs as: "companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding EUR 43 000 000 and an annual net turnover not exceeding EUR 50 000 000". This definition also avoids necessarily considering SMEs depending on their number of employees, which may disadvantage investment into SMEs active in labour-intensive industries compared to tech-intensive industries.

<u>Example 2: MIFID professional investors' definition</u>

<u>Relevant legislation</u>: MIFID II, Annex II- definition of "professional investors"

<u>Summary:</u>

Private equity funds will, alongside such institutional investors as banks, pension funds or insurers, also admit as investors a number of high-net worth and/or sophisticated individuals, many of whom will have significant experience of investing in private equity funds or in entrepreneurial businesses. Such investors are categorized as "retail" investors under Annex II of MiFID II.

In theory, MiFID II allows these investors to become "elective" professional investors. To be categorised as professional clients "upon request" they must satisfy a "two out of three" quantitative test. For reasons outlined below, it is can be difficult for many investors, even highly sophisticated and/or ultra high net worth individual investors, to satisfy two of these tests *in a private equity context*.

At the same time, these investors are not *typical* retail investors either – often having extensive industry or sector experience (for example in an operational role or as an entrepreneur) that provides a sophisticated understanding of the specific investment into a private equity or venture capital fund that they are intending to make. Furthermore, investments made by executives, directors or employees involved in the management of a fund would also be considered retail investment unless stated otherwise.
While high standards of protection are necessary for retail investors, use of the MIFID definition in other legislation may prevent fund managers from being able to access these experienced investors – and in turn prevent these investors from investing their capital and expertise in these funds and in the businesses they support.

<u>Evidence:</u>

Examining the three elements of the MiFID test shows the definition clearly favours some type of investments independently of the risk they carry. While the proposed test tries to take into account the diversity of financial investors, it fails to do for the following reasons:

- The first test ("frequency") is inherently discriminatory due to the long-term and illiquid nature of private equity. The test is calibrated for participants in liquid markets such as those for exchange-traded equities but it is applied in other contexts such as the marketing of interests in private equity funds. Not even the most seasoned institutional investors make as many as 10 commitments per *quarter* to private equity funds. These investors will typically build portfolios of say 20-40 private equity fund managers over a number of *years* in order to spread vintages and manage cash-flows.

- The third test ("expertise") may be met by some investors but not by new entrants (such as serial entrepreneurs who decide to invest into a fund for the first time). Most high-net-worth-individuals and business angels as well as entrepreneurs will not have worked in the financial sector, but are very well suited to invest in venture capital and private equity funds, bringing with them both capital and expertise in building companies.

The MiFID definition is reproduced in various pieces of law, such as in AIFMD, Prospectus or KID-PRIIPS, and has the following effects::

- **AIFMD**: Article 43 gives Member States the discretion to allow fund managers to market to retail investors. As a result, many Member States prevent private equity managers from marketing to certain or all types of retail investors while others incentivise them to do so (e.g. VCTs in the UK). While the absence of European harmonisation, outside of the EuVECA regime, may make sense for genuine retail investors, in order to allow some flexibility for Member States when it comes to the protection of their citizens, it risks discouraging investment by sophisticated investors into private equity and venture capital.

- **KID-PRIIPS and Prospectus**: As explained in our response to example 2 of Issue 3, a fund manager will be required to produce a Key Information Document and a Prospectus (when it is issued to more than 150 people) for all types of non-(elective) professional investors, some of whom will have such a level of expertise and understanding as to make this redundant.

- **ELTIF**: Only certain types of retail investors will be entitled to invest in an ELTIF. The fact that semi-professional investors are not recognised as a category across EU legislation creates additional cost and complexity for asset managers. Larger managers with multiple product lines may be discouraged from seeking to access a regime such as ELTIF as they will find it difficult to manage the compliance risk that arises from being able to market one product to ELTIF retail investors on an EU-wide basis, but not market other products to a materially similar category of investors in the same way. Different investor relations approaches and systems need to be put in place for multiple product lines. As a minimum this increases complexity and leads to higher costs (which will be tend to be borne by investors); at worst it will lead asset managers to decline to offer certain products (with impact on investor choice).

Importance of semi-professional investors to private equity and venture capital

This lack of harmonization and these new requirements – the effects of most of which remain to be seen - would not be an issue if "sophisticated" investors were not an important part of the investor base, in particular for venture capital, something that was partly recognised in the EuVECA Regulation.

From 2009 to 2014, 12% of the investment into venture capital was made by private high-net worth individuals, 10% by corporate investors, 5% by family offices and 3% by endowments and foundations, all investors who will in most cases not be considered as professional investors but which will mainly fall under the semi-professional definition. Combined investments made by these categories represent twice as much investment as that coming from traditional investors such as banks (5%), pension funds (8%) and insurance companies (3%) according to 2014 Invest Europe statistics. This shows that, despite the fact that many EU countries prevent AIFs to market to so-called retail investors, these investors constitute an important source of financing for venture capital funds. In light of the importance of these investors, differences between regimes may be one of the reasons behind the fact that 90% of venture capital investment is coming from only 9 European countries, which recognise the specificity of these investors.

Remedies:

While the best option would remain to amend the exiting Annex in MiFID2 to take these elements into account, the creation of a new category of 'sophisticated' investor, as it exists in EuVECA, would provide a much needed layer of flexibility and better represent the diversity of the financial investors. This category could equally be extended to other legislation targeting retail investors, such as KID-PRIIPS.

Removing the quantitative requirement for a minimum number of transactions and introducing a simple minimum wealth level or minimum investment threshold would instantly widen the scope of the marketing passport, ease fundraising and fit the realities of private equity. This would not damage investor protection since there would still be the requirement to ensure that the investor had appropriate knowledge and experience to understand the risks involved.

Issue 12: Overlaps, duplication and inconsistencies

Example 1: Shareholders' Rights Directive- Duplicative requirements

Relevant legislation:

Shareholders' Rights Directive, Article 3f, g and h (Chapter Ib), as proposed by the European Commission.

Concerns set out below apply to the text adopted at first reading by the European Parliament and to the Council general approach, both of which follow the lines of the Commission examples.

Summary:

We are concerned by the duplication of disclosure requirements for fund managers regulated under the AIFMD and who fall under the scope of the Shareholders' Rights Directive. For more explanation as to why this issue is relevant for private equity funds, please see our Example 1 in our response to Issue 3.

Evidence:

Alternative investment fund managers must already comply with different disclosure requirements as set out in the AIFM Directive. Here are a few examples of duplicative rulemaking which, if the Commission original SRD text was to be adopted, would fall twice on the fund manager's compliance teams:

- The obligation for the asset manager to disclose to the institutional investor elements of their investment strategy (Article 3h.1) is already set in Article 105 of AIFMD Delegated Regulation 231/2013, which states that an overview of the investment activities and the AIF portfolio must be included in the report on activities of the financial year.
- The obligation to disclose element such as the portfolio turnover costs would also not bring any benefits in light of Article 23 of AIFMD which already requires AIFs to provide a description of all fees, charges and expenses borne by investors.

- The requirement to manage conflicts of interests in regard to shareholder engagement (Article 3f, 2) can also be found in Article 14 of AIFMD.
- More generally, Article 30 to 36 of Regulation 231/2013 details precisely the types of conflict of interests that should be addressed and the procedures to manage these; and AIFMD already contains an Article on strategies to determine voting rights (Art 37).

Given this, we feel the proposed requirements included in the Shareholders' Rights Directive do not bring any new protection for the consumer, present a new cost to the fund manager and may create additional regulatory uncertainty given these obligations will need to be transposed in national law.

Remedies:

As explained in our example 1 on Issue 3, one simple solution would be to adapt the definition to exclude private equity funds from the scope of the Directive, recognizing that they are already regulated under a sectorial legislation. Another way to achieve this objective would be to add a cross-reference to the AIFMD in the text of the Shareholders' Rights Directive, as was suggested during negotiations.

Example 2: Solvency II: transitional provision measure for standard equity risk

Relevant legislation: Solvency II, Article 173 of Delegated Act EU/2015/35 (including as modified by upcoming Commission Delegated Regulation on Solvency II published alongside the Capital Markets Union Action Plan)

Summary:

The draft article provides that "the transitional measure for standard equity risk set out in Article 308b(13) of Directive 2009/138/EC shall only apply to equities that were purchased on or before 1 January 2016". The Directive and the new Delegated Act give no guidance as to how the "date of acquisition" should be interpreted for the purpose of the transitional rule. Recital 4 of the draft ITS, as proposed by EIOPA on 27 November 2014, specifies that "the acquisition date for equities within collective investments must be based on a look through approach" (i.e. applied to each individual equity holding within the collective investment).

We believe that this approach would be inappropriate for collective investment funds, and particularly of private equity funds, and would not recognise their specific characteristics.

Evidence:

A private equity fund is typically structured as a limited partnership. The fund invests in unlisted equities and usually has a minimum life-span of 10 years. Investors participate by making a legally binding commitment to provide a specified amount of capital to the fund for investments. However, the capital committed is not paid immediately on a fund's 'closing' but in tranches that are drawn down over the commitment period. It takes considerable time and effort for the manager to identify, carry out diligence on and negotiate the acquisition of the shares of an unlisted company, compared to stock-picking listed equities for example. The fund manager therefore draws down from this capital pool of commitments to fund the equity investment in a diverse range of portfolio companies over the course of the fund's investment period (typically 5-6 years of the fund's life) as and when the capital is required.

From the perspective of the Solvency II regulated insurer, the 'investment' is made when it makes a legally-binding commitment to the fund by signing the partnership agreement. The date when the individual fund makes an equity investment in a specific company or the date when the investor pays one of its contribution tranches (i.e. the commitment is drawn down) is not the relevant event because the investor has no control over when this happens, as it is the manager of the fund who has sole discretion over the decision to make an underlying investment and to draw down committed capital from investors. By signing the agreement the investor acquires all rights and obligations as a limited partner (LP) and has the obligation to to pay over to the fund the total amount committed as required under the draw down terms of the fund.

In light of this, the transitional rule should capture those situations where investors have already made long-term commitments (i.e. the situation where they have already made the investment), as in many cases their ability to change those investments will be very limited, if not impossible (and even if possible may prove detrimental to the implementation of the investor's investment strategy).

Remedies:

Taking into account these features of private equity we strongly believe the look through approach provided in Article 84(1) of the Delegated Act should not be used to determine the date of acquisition for the purpose of the transitional rule. In our opinion, only the date of the investment, i.e. commitment to the co-investment arrangement/fund by the investor is relevant and not the later dates when the fund makes individual investments, not least because in legal terms the investors' investment is in the fund, not in the underlying investments made by the fund.

Example 3: Group definition

Relevant legislation: Accounting Directive 2013/34/EC; EMIR, Art 2.16; MiFID II, Art 57

Summary: Directives and Regulations that refer to the Accounting Directive 2013/34/EC may impose obligations to private equity fund managers due to the definitions of parent and subsidiary undertakings which are not suited to their businesses.

Evidence:

Since the adoption of the Accounting Directive 2013/34/EC, groups are defined as "a parent undertaking and all its subsidiary undertakings". What determines whether an entity is a subsidiary of a parent undertaking is the notion of "control". Recital 31 of the Directive details the specific circumstances in which control is deemed to be exercised. The Transparency Directive also suggests in its definitions what a "controlled undertaking" is.

Definitions of parent and subsidiary undertaking – and by extension the definition of a group - have been cross-referenced in other pieces of financial services legislation that are seeking to pursue very different objectives. This is in particular the case of EMIR and MIFID2 – which respectively clarify at which level positions limits should be aggregated and to which entities the clearing threshold should apply.

Why private equity firms and their portfolio companies are not groups

While the relationship between a private equity fund and its portfolio companies is fundamentally different from the one that exists in a corporate group or a conglomerate, many private equity fund structures will fall under the definition of "group" as currently defined in EU law depending on whether the fund is the parent undertaking of its portfolio companies and whether the fund manager is the parent undertaking of the fund. This is a complex and fact-specific area.

Private equity firms typically select portfolio companies in which to invest. The intention of the PE investor is to develop and grow each company with the objective of increasing its value for eventual sale. To achieve this, fund managers acquire shareholder rights to hold a minority or majority ownership in these companies and from a legal perspective these may be group undertakings. However, in practice: (i) these portfolio companies will run independently of one another and the ultimate parent company (e.g. the fund itself); and (ii) the financing structures of each portfolio company will not be cross-collaterised.

From an investor/PE fund manager perspective, its business purpose will be to invest funds solely for returns from capital appreciation or investment income or both. This is very different from seeking benefits from the operational activities of the portfolio company it has invested in. The PE fund manger will therefore evaluate performance of its investments in portfolio companies on a fair value basis. This distinction is recognised in international accounting standards which require funds that meet the definition of an investment entity to account for their investments at fair value rather than consolidate them.

Therefore while accounting standards (and the reports sent to investors) recognise this relationship between the private equity fund and the portfolio companies it is backing, applying other regulation simply on the definition of a parent/subsdiary/group undertaking in EU law will not acknowledge the fact that portfolio companies are separate and unconnected in a business sense.

Why is this a problem?

(1) Accounting Directive

Since PE funds do not prepare group financial statements that consolidate the results of portfolio companies, generating any information of this type is cumbersome and impractical.

(2) EMIR

The definition of a group in this Regulation is relevant to determining where the clearing threshold needs to be calculated (and thus whether it has been breached). When acquiring a company, private equity funds invest via a holding company – a special purpose vehicle (SPV) - which then in turn acquires the shares in the operating portfolio company. When derivatives are entered into by a portfolio company, or its holding company, for example for hedging purposes, these are transacted by each SPV or portfolio company, without any exposure to the fund. Derivatives entered into by the SPV will therefore have no impact on the fund or on its other investments.

Provided the risk is ring-fenced in each of the SPVs / portfolio companies, it would not be appropriate to apply the clearing threshold at the level of the fund or fund manager, and to treat the many portfolio companies into which it has invested as part of the same group. Most importantly, given the lack of exposure between the different entities, imposing a threshold at the size of the fund would not achieve the overall objective of reducing systemic risk. Recital 31 of EMIR states in that effect that "appropriate efforts should be made to recognise the methods of risk mitigation used by non-financial counterparties in the context of their normal business activity"

(3) MiFID2 (Art 57)

The same problem arises with commodity derivatives aspects of MiFID II (Art 57) where Member States' competent authorities must establish and apply limits on the size of a net position which a person can hold in commodity derivatives. Here again the limits are set on the basis of all positions held by the person and those held on its behalf at an **aggregate group level**.

This may create a problem for private equity funds which have invested into several portfolio companies which engage in commodity derivatives. Given that the fund will be considered as a parent undertaking, there is a risk that when the portfolio companies cannot take advantage of the non-financial entities exemption their positions will need to be aggregated, and this despite the fact that the fund might not exert any control on the trading activities of these entities.

Remedies:

Regulation such as EMIR and MiFID II should take into account the specific features of investment structures when applying the group definition as the additional regulatory obligations will not be consumerate the risks posed.

More specifically, we believe it should be made clear that a private equity fund and its portfolio companies are not considered as a group, on a case by case basis, depending on the policy objective.

- On EMIR, private equity funds and their portfolio companies should never be considered as a group for the purpose of calculating the clearing threshold.

Such an exemption is justified as any derivatives contracts entered into by one portfolio company create no exposures for other portfolio companies into which a fund has invested.

- On MIFID, a private equity fund which has control of an financial entity that holds positions in commodity derivatives shall only be required to aggregate the positions of its portfolio companies if it exerts an effective control on the trading activities of these entities.

Such an exemption is justified as the objective of the Commission is to ensure that fund managers who do not have control on the holding of position limits of both the portfolio companies they are controlling should not be forced to aggregate the size of their respective position limits.

Example 4: Shadow Banking : inconsistencies with international framework

Relevant legislation: EBA Guidelines on Limits and Exposure to Shadow Banking (CRD4/CRR)

Summary:

Last December the EBA finalised its Guidelines on the definition of shadow banking entities. While AIFs are excluded as long as they do not employ leverage on a 'substantial' basis and do not originate loans, we are concerned that the proposed Guidelines are not in line with the methodology proposed by the Financial Stability Board (FSB), which could:

(1) potentially catch entities that never perform shadow banking entities' economic functions
(2) lead to significant inconsistencies between regulators.

Evidence:

Although the FSB, initially identified certain types of entities, including some fund structures, as being potentially involved in shadow banking, its detailed assessment of these entities, led it to conclude that there is "a high degree of heterogeneity and diversity in business models and risk profiles not only across the various sectors in the non-bank financial space, but also within the same sector or entity-type"[5].

Based on this assessment, the FSB concluded there is no merit in seeking to pin particular types of fund as 'shadow banks', given the variety in structure and activity undertaken even amongst funds bearing the same broad title. As a result, the approach adopted by the FSB allowed the extent of non-bank financial entities' involvement in shadow banking to be judged by looking through to their underlying economic functions, rather than focussing on their legal names, forms or regulatory frameworks.

Differences between the FSB and EBA approaches

The EBA in its Guidelines on the Limits and exposures to Shadow Banking, in the context of CRR, which were published in December, do not follow this approach. Rather than assess whether an entity is engaging in one of the 5 economic functions determined by the FSB, th e EBA defines shadow banking as "undertakings that carry out one or more credit intermediation activities" – an extremely broad definition- and, in a second step, carves out entities <u>if and only if</u> they comply with specific requirements. As a result, and contrary to the FSB, an entity will be deemed, *prima facie*, to be a shadow bank, unless it can prove otherwise. This approach, which reverses the burden of proof, bears a significant risk of identifying undertakings which do not perform the economic functions defined by the FSB as "shadow banks".

The private equity example

Private equity funds are a good example of the risks of the EBA approach. As we explained in Example 4 of Issue 4, private equity funds have been identified in European legislation as "alternative investment funds", and comply with the same requirements as all non-UCITS funds, despite having very different characteristics.

In its Guidelines, the EBA recognised that there were differences between types of alternative funds and stated that non-substantially leveraged AIFs would not be considered as shadow banks. While this acknowledgement is welcome, and is in line with other pieces of legislation such as Solvency II Delegated Acts, it must be stressed that leverage is a technical measure of exposures and is not in itself related to the operation of one of the five proposed FSB economic functions. In other words, while the exclusion of closed-ended and non-substantially leveraged funds introduces some distinction between AIFs, it does not use the economic functions determined by the FSB.

Remedies:

We appreciate the EBA's recognition that all AIFS are not identical and do not pose the same risk. Private equity funds have neither the characteristics nor the level of risk of credit institutions that would justify their identification as shadow banks, and the exemption of all AIFs which do not use leverage on a substantial basis is a welcome step.

[5] Financial Stability Board, "Strengthening Oversight and Regulation of Shadow Banking - Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities", 29 August 2013

However, the FSB's more granular approach ensures that shadow banking entities are identified on the basis of the activities and of their economic functions, rather on their name or their regulatory classification, which, as described in other examples to this response, may have their limits.

For this reason, we believe the EBA Guidelines – and other relevant pieces of the EU legislative framework - should more appropriately reflect the FSB work in their search to define so called "shadow banking entities". As demonstrated above, the EU approach risks capturing as "shadow banks entities that do not carry out any of the five economic functions suggested by the FSB.

Contact

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

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