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

Response to the Joint Consultation paper on PRIIPS Key Information Documents draft regulatory technical standards

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.

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Introduction

The Public Affairs Executive ('PAE') of Invest Europe, the association representing the European private equity, venture capital and infrastructure investment industry appreciates the opportunity to respond to this Consultation on the draft regulatory technical standards ("RTS") with regards to presentation, content, review and provision of the KID.

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.

While we fully support European legislators' efforts to improve the transparency of information on investment products provided to genuine retail investors, we are concerned that certain elements of the draft RTS could have unintended (and unwelcome) consequences for the private equity industry, which would further run counter to the European Commission's plans for a Capital Markets Union ('CMU'). Our position remains that semi-professional investors, as defined in the EuVECA Regulation, should benefit from differentiated treatment to retail investors as the professional investor definition under MiFID2 does not take into account the specific characteristics of the private equity and venture capital industry. This in turn disadvantages long term investors who invest in the industry.

Whereas capital committed to private equity and venture capital funds still comes largely from institutional or semi-professional investors in many Member States, smaller retail investors have had access to the industry through a number of different vehicles that enable them to invest either directly or indirectly. These investment vehicles include listed private equity vehicles, Venture Capital Trusts in the UK, "Fonds commun de placement dans l'innovation" in France and listed funds of funds.

In this response we address only the issues that arise when funds are directly marketed to retail investors, and in particular to those that are semi-professional investors (as defined in EuVECA Article 1.6). As we have indicated in previous submissions that we have made in relation to the PRIIPs Regulation and as we will indicate in our response to the Commission Call for Evidence on the EU Regulatory Framework for Financial Services, the proposed RTS are not well suited to the characteristics of this asset class.

Even if direct investment into private equity funds by retail investors is still limited, it is important that the requirements imposed by the RTS do not lead to an inaccurate or misleading impression being created of the type and level of risk it represents.

Our concerns

Our key concerns with the draft RTS relate to the inappropriate treatment of the private equity asset class in (i) the assessment of its risk; and (ii) the characterisation and treatment of carried interest (a feature of private equity) as 'costs' to be borne by retail investors.

We are concerned that private equity funds have been singled out and assigned a market risk measure of class 6 without an appropriate justification. There is no legal or economic rationale to distinguish - as is currently proposed in Annex II, 14, i. and iv - private equity funds from other illiquid closed-ended and long-term investment funds, such as ELTIFs and real estate funds.

We also disagree with the proposed treatment of carried interest as now described in Annex VI of the draft RTS. We believe the current approach to be unclear and to pose a meaningful risk that retail investors will be presented with inaccurate and misleading information about private equity and venture capital investments. Requiring fund managers to compute carried interest as part of the cost table of the KID risks incorrectly equating this aspect of private equity with a performance fee or compensation (it is neither). It further risks giving the investor the impression that this will be due on invested capital, when in practice it is a percentage share of realised cash returns that the fund manager *only* receives when an agreed return has been achieved by the investors.

Finally we would like to stress the importance of the tax regime applicable to an investment - and particularly any tax incentives that may be available to the investor. While it is not appropriate for the KID to offer detailed advice on the specific tax treatment of any product (not least because this can change and can be dependent on an individual's specific circumstances), the manufacturer should nonetheless be able to note in general terms that the tax treatment of the product may be a relevant factor to consider and on which the retail investor may wish to seek appropriate advice. This is particularly important for venture capital funds investing into innovative SMEs, which can be supported by Member State governments through tax incentives.

Question 1

Would you see merit in the ESAs clarifying further the criteria set out in Recital 18 mentioned above by way of guidelines?

The wording of the existing recital seems to indicate that products in which retail investors do not usually invest would be considered as 'not simple'. This risks prejudicing the development of new investment channels, implying that anything new or innovative *must* be complex - and therefore by implication less suitable. Such an approach is not to be welcomed and should be taken into account by the ESAs during any clarification of the criteria through guidelines. This recital must neither jeopardise the incentives for innovation nor act as a barrier to retail investors being able to secure appropriate access to such new products.

Question 2

- (i) Would you agree with the assumptions used for the proposed default amounts? Are you of the opinion that these prescribed amounts should be amended? If yes, how and why?***
- (ii) Would you favour an approach in which the prescribed standardised amount is the default option, unless the PRIIP has a known required investment amount and price which can be used instead?***

As we explained in our response to the second technical discussion paper, setting a default amount of €1,000 is arbitrary and low given the size of commitments usually made by investors in private equity funds.

While we recognise a standardised investment level could be useful for the investor when making comparisons across different products, it could produce odd results in certain situations where funds, such as private equity funds, have a low volume of high value transactions. We therefore believe that where there is a required investment amount, it should be possible to use it.

Question 8

Do you agree with the scales of the classes MRM, CRM and SRI? If not, please specify your alternative proposal and include your reasoning.

We have concerns about the treatment of the private equity funds asset class, which leads to it being assigned a MRM - and therefore a SRI - of 6.

Although we recognise that private equity investments are inherently illiquid, we are concerned by the absence of any justification for the proposed treatment of private equity in the regulatory technical standards (Paragraph 14 of Annex II, Part 1 of the RTS). While according to this paragraph and paragraph 13b, closed-ended investment funds and long-term investment funds that invest at least 30% in illiquid assets are by default assigned the MRM of 5, private equity funds are specifically carved out from this regime and assigned to a higher risk class.

The PAE of Invest Europe is of the view that this does not reflect the risk investors face when investing in this asset class and may act as an artificial disincentive to investors to invest in private equity and venture capital, compared to other investments that are similar in nature.

The approach being proposed is not in line with recent legislative developments at EU level which have recognised that all “closed-ended and non-substantially leveraged funds” - a category into which many private equity funds would fall - should be given specific treatment. In the recent Solvency II delegated act and in the EBA’s recent work on shadow banking, such an approach has been used to identify those funds with characteristics that should be regarded as being of lower risk. The actual characteristics of these funds (i.e. that they are closed ended and do not deploy significant amounts of leverage) has been used to determine their treatment. In the absence of a definition, the use of a label or name (such as ‘private equity fund’) leads to a lack of clarity and arbitrarily assigns a risk categorisation to a potentially very diverse set of funds (including venture capital). We therefore believe the blunt distinction made by the ESAs is artificial and does not reflect the actual riskiness of our asset class or its treatment in other existing legislation.

Retail investors will already receive information on the liquidity risk, which will be particularly important in helping them to understand whether such an investment is suitable for them. In that regard, we fully support the draft regulatory technical standards’ requirement that liquidity risk should be described in the narrative rather than within the summary risk indicator. This will allow investors to clearly understand that they would need to have enough resources to meet future capital calls, without giving them a misleading assessment of the other risks they would face compared to other products.

Question 14

Do you agree to use the performance fee, as prescribed in the cost section, as a basis for the calculations in the performance section (i.e. calculate the return of the benchmark for the moderate scenario in such a way that the return generates the performance fee as prescribed in the cost section)? Do you agree the same benchmark return should be used for calculating performance fees for the unfavourable and favourable scenarios, or would you propose another approach, for

instance automatically setting the performance fees to zero for the unfavourable scenario? Please justify your proposal.

We understand the rationale behind using the performance fee as a basis for calculations of possible performance of the fund, but this approach might not be suitable in the case of private equity funds.

As we explain in detail in our response to Question 23, carried interest is a profit share mechanism, which aligns the interests of fund managers with those of investors. While carried interest is linked directly to the performance of the fund, there are several elements of the carried interest arrangement and its calculation, which makes it different from traditional performance fees, including:

1. **Carried interest is typically not paid each year:** while carried interest arrangements are agreed at the outset of the fund, cash will typically only be paid by the fund to the carried interest participants once investors have had their drawn capital back *plus* an agreed preferred return (see point 2). The period between the agreement of the carried interest arrangement and cash being paid out will typically exceed the time periods proposed in the KID (However we note that the RTS acknowledge that for illiquid products, performance scenarios should be calculated using only the recommended holding period/maturity and not interim periods as well).
2. **Carried interest is usually only paid above a “preferred rate of return”:** at the outset of the fund, fund managers and investors agree the detailed terms of the carried interest arrangement. This will include a level of return (the preferred return) that will accrue exclusively to external investors, and the pre-determined formula for how returns *above* this threshold will be shared between the fund manager and these external investors. This means that any investors into the fund will see *both* the payment of their original investment *and* an agreed return before any carried interest is paid to the fund manager. For the same reason, there is therefore no guarantee that carried interest will ever be paid: if the fund does not achieve this pre-determined level of return there will be no carried interest.

For the reasons above, it will not be possible to use the same benchmark return for calculating performance fees for the unfavourable or favourable scenarios. It would be more logical to automatically set the performance fee to zero for the unfavourable scenario. More details on possible carried interest scenarios can be found under Question 23.

Question 15

Given the number of tables displayed in the KID and the to a degree mixed consumer testing results on whether presentation of performance scenarios as a table or a graph would be most effective, do you think a presentation of the performance scenarios in the form of a graph should be preferred, or both a table and a graph?

Presentation of the performance scenarios in the form of a graph may be more suitable for liquid products and are likely to give investors misleading information for illiquid investments. For investments in closed-ended and illiquid funds such as private equity, where an investor has a contractual obligation not to withdraw his or her commitment before the end of the life of the fund, the concept of a return after 1 or 3 years is in most cases irrelevant. Presenting this information in the form of a table would therefore be more suitable.

Question 18

Do you agree that the monetary values indicated in the first table are a sum of costs over the respective holding periods? Or should the values reflect annualized amounts? If you prefer

annualized amounts, which method for annualisation should be used (e.g. arithmetic average or methods that consider discounting effects)?

The presentation of costs in Annex VII requires amounts to be presented on the recommended hold period as well as two interim periods. This is inappropriate in the context of funds with little or no liquidity and is inconsistent with the approach taken for the presentation of performance scenarios. Private equity funds can be characterised by high value, low volume transactions (compared to mainstream funds) that span the investment period of the fund (typically the first five years) and the pattern of investment will vary for a number of different reasons. Attempting to compute costs in interim periods will therefore be misleading and amounts should only be presented for the recommended holding period. This approach will follow that taken for performance scenarios and will be easier for the investor to understand as the two will link together. As a consequence, the sum of costs should be presented rather than annualised amounts.

Question 23

The example presented above includes a possible way of showing the variability of performance fees, by showing the level for all three performance scenarios in the KID, highlighting the ‘moderate’ scenario, which would be used for the calculation of the total costs. Do you believe that this additional information should be included in the KID?

Carried interest has been included as an incidental expense in the RTS alongside performance fees. (We also note that the RTS should refer to it as carried interest rather than carried interests). We would like to stress again that it is inappropriate to include carried interest in the cost section and detail our reasoning below. We also suggest an alternative solution.

Carried interest is an agreed percentage of the cash profits of the fund. This will be paid out to the manager and subsequently to its executives who participate in the carried interest arrangements only once the external investors have:

- received back all of their drawn down capital (including typically also amounts drawn to pay the management fee);
- *plus* an agreed preferred return.

Carried interest is generally regarded as the main incentive to the fund manager and is a key mechanism for aligning the interest of the fund manager and investors. It is typically presented as an allocation of profits in the accounts for the fund sent to investors and not as a fee. We do acknowledge that carried interest has been given its own heading under incidental costs and not under performance fees. However this also needs to be reflected in the tables setting out the presentation of costs in Annex VII i.e. were carried interest to be included in the costs section then then firms should at least be able to label it as carried interest and not as a performance fee.

According to the proposed methodology, anyone marketing a closed-ended fund to a retail investor will need to estimate their return by using a proxy (a comparable fund or a peer group) and adjust this for differences in costs charged to the new fund. By definition, no historical data will yet be available as the manager will still be in the fundraising stage of that fund's life.

Most private equity fund vehicles having to draw up a KID will find themselves in this situation and this will lead to three major issues:

- a. The methodology would seem to require carried interest to be calculated as a **percentage of the original investment**. However, in fact, it is a share of **realised gains**. The RTS therefore risk generating a percentage figure that is misleading.

Solution: carried interest should be calculated as a percentage of returns - and therefore directly connected to the performance of the fund - and not of the investment.

- b. The actual amount of carried interest **may differ significantly from the amount required to be shown in the KID**.

Issue: In the absence of historical data at the fund level, the carried interest disclosed in the KID will be estimated based on a comparable fund or peer group. The calculated return will be therefore based on:

- funds with a return below the preferred rate of return where no carried interest will be paid; and
- on the other end of the spectrum, very successful funds for which carried interest could be unusually high (in absolute numbers).
- most importantly, funds which do not follow the same specific strategy of the fund for which the KID is being produced

As a result, given the very wide range of potential values in the calculation, the carried interest effectively paid to the fund manager may be fundamentally different from the amount specified in the cost table of the KID.

Solution: In order for the carried interest calculation to be meaningful, it would make more sense to adjust the comparable fund or peer group data for points of difference in the investment strategy of the fund and other known variables (i.e. geography, markets, etc) rather than only adjusting this data for costs. There are a wide range of strategies adopted by private equity managers and even though other funds may appear to follow comparable strategies in a broad sense, there will be differences. A much easier solution would be to correlate the calculation of carried interest with the performance scenarios. This impact on performance could easily be computed using the terms of the carried interest arrangement. Depending on the specific level of performance chosen, the 'unfavourable' and/or 'moderate' scenarios would demonstrate that no carried interest would be paid at those rates of return. Carried interest would be paid under the 'favourable' scenario (again depending on the specific level of performance applied to this scenario) and its effect on the investor would be shown by the impact on returns. This would be a more accurate and meaningful approach to the treatment of carried interest.

- c. the KID does not specify anywhere that **no carried interest will be paid below the preferred rate of return**

Issue: Manufacturers will be required to specify in the KID a supposed 'cost' that may never have to be paid.

Conclusion: For these reasons, we believe carried interest should only be computed as part of the performance scenarios and not treated as a 'cost'. The impact on the return the investor might expect under the favourable (and potentially the moderate) performance scenario should be set out, but carried interest should not be treated as a regular cost or a performance fee. This impact on the returns enjoyed by the retail investor could easily be calculated using the terms of the carried interest arrangement and the performance scenarios. Reference to carried interest should therefore be removed altogether from the cost section.

The table below describes the relevance of a performance-related approach compared to the one proposed in the draft RTS.

<u>Approach taken</u>	<u>Cost approach</u>	<u>Performance-related approach</u>
Method of calculation	Presented as a percentage of the initial investment (a representation that is factually wrong)	Presented as a percentage of the returns that are achieved (which makes clear that carried interest is not deducted from the original investment)
Level of detail given	One single figure (likely to be calculated on the basis of the historic performance of a broad range of funds and not adjusted for points of difference in the investment strategy)	One figure for each of the 3 scenarios (which is a more accurate representation of the profile of payments, such as the distinction between the preferred rate of return paid to investors and carried interest paid to fund manager/participants)
Precision of the information	Broad estimate based on the historic performance of a broad range of funds	Specific amount that would be paid (based on each of the scenarios)

In order to implement this solution, a paragraph could be added in Article 7 of the RTS stating that the amount of carried interest paid should be subtracted from the proposed performance computed in the different scenarios.

Notwithstanding that carried interest should be removed from the cost section altogether, should the final RTS fail to make this change, then they should specify that carried interest is not calculated as a percentage of the investment but of the final return. As described in our response to Question 24, the cost table would then need to take into account the different performance scenarios. In order for an investor to be fully aware of the implications, the KID could also contain in the cost or performance section a requirement to explain in simple terms the carried interest arrangement and its impact on returns above a threshold which has been determined at the outset.

Question 24

To reduce the volume of information, should the first and the second table of Annex VII be combined in one table? Should this be supplemented with a breakdown of costs as suggested in the graphic above?

For closed-ended private-equity funds - and more generally for similar types of illiquid funds - the tables in the first two scenarios (“if you cash in after 1 or 3 years”) do not reflect the nature of the fund i.e. where investments are made over a defined period in the first part of the fund’s life. A reference elsewhere in the KID about the liquidity risk gives clearer and sufficient information to the investor about the contractual obligation to invest over the entire life of the fund. Please also see our response to question 18. We therefore favour an option that would give greater prominence to the scenario in which the investor remains invested until the end of the fund’s life (as envisaged at the outset) and incorporates the impact of carried interest with the performance scenarios rather than a fixed investment amount (see also our response to question 23 for further detail).

Question 26

Regarding the first table of the cost section presented in Annex VII, would you favour a detailed presentation of the different types of costs, as suggested in the Annex, including a split between one-off, recurring and incidental costs? Alternatively, would you favour a shorter presentation of costs showing only the total costs and the RIY?

The current format is appropriate (noting our response to questions 23 and 24) as producing a total figure does not show sufficient information to the investor and could be misleading.

Question 27

Regarding the second table of the cost section presented in Annex VII, would you favour a presentation of the different types of costs showing RIY figures, as suggested in the Annex, or would you favour a presentation of costs under which each type of costs line would be expressed differently, and not as a RIY figure -expressed as a percentage of the initial invested amount, NAV, etc.?

For the reasons given in our responses to previous questions (in particular 2 and 23), the current proposed approach is appropriate.

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.

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