European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

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

**May 2014**

# Position Paper on the European Commission Proposal for a Regulation on structural measures improving the resilience of EU credit institution

## I. General comments

The private equity (including venture capital)[1] industry plays an important role in delivering smart, sustainable and inclusive growth that creates jobs and enhances the long-term competitiveness of the European Union. This role partly depends on the relationship of the private equity industry with banks and therefore the proposal on structural measures should not ignore the benefits this relationship can bring.

We support the overall objectives of the proposal and welcome the recognition of the positive role of private equity in financing the real economy. However we are still concerned with the potential negative impact it may have on private equity funds. In some cases the proposal does not appear to treat banks' relationships with private equity funds appropriately and this may prevent our industry from delivering the benefits that the private equity model can bring.

## II. Exemptions from the proprietary trading ban - Article 6(3)

Article 6 of the proposal on structural measures prohibits banks from engaging in proprietary trading in financial instruments, trading of commodities and investing in hedge funds. However the proposal allows banks to engage in certain activities that are beneficial for the real economy. Therefore Article 6(3) provides an exemption for a limited group of funds, given their positive contribution to the economy.

[1] The term "private equity" is used in this paper to refer to all segments of the industry, including venture capital. The term "venture capital" is used in specific contexts where there are issues that relate particularly to this segment.

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

The private equity industry appreciates the fact that the proposal recognises private equity's positive role in supporting the financing of the real economy, classifies them in the group of funds that can benefit from the exemption and differentiates them from other alternative investments funds. However, we consider the exemption in Article 6(3) to be too restrictive as it may not extend to all of those types of private equity fund that are investing in the real economy.

### i) Exemption for private equity funds

According to Article 6(3) private equity funds are exempted from the ban on proprietary trading provided that they are close-ended and unleveraged. This is indeed welcome recognition for private equity's positive role. However, there are closed-ended AIFs, which have equally important and beneficial role for the real economy and which may deploy a limited amount of leverage, but not substantial and in any event far smaller than most financial institutions, whether banks or hedge funds.

As explained in more detail later in the paper, private equity funds typically incur temporary, relatively short-term bridge finance at the fund level and may occasionally enter into short-term currency hedges. These facilities are used for specific purposes and are usually backed by the 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 by funds drawdown from investors.

In some cases these types of facilities (which only help to bridge the gap in funds' cash flows) may be considered as leverage and therefore prevent some private equity funds from benefitting from the exemption in Article 6(3) of the structure of banking proposal. Therefore in our opinion 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.

We consider that the approach taken in the proposal is not justifiable given the nature and scale of the risks that a bank would face through its relationship with private equity. It does not seem to take into account the comprehensive reform that has taken place in the European financial regulatory framework, which now

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

ensures an adequate regulation of risks, from both banks' and funds' perspectives[2]. **We are of the opinion that the exemption for private equity funds should rather be built on the distinction between AIFs that are *substantially* leveraged and AIFs that are *not substantially* leveraged**

The concept of "substantial leverage" is already defined in the EU law in the AIFMD framework [3] .The 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 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.

### ii) Non-EU AIFs and Non-EU AIFMs

Moreover if closed-ended and unleveraged AIFs wish to be exempted from the ban they also need to be established in the EU or if they are not established in the EU they need to be marketed in the EU according to Article 35 or 40 of AIFMD. This means that only non-EU AIFs that are marketed in the EU with a passport will benefit from the exemption from the proprietary trading ban. Other non-EU AIFs, which are either marketed without a passport or are not marketed in the EU, will not be allowed to use this exemption.

We do not believe that this is the right approach as it would not allow certain AIFs that can positively contribute to the financing of the economy, to benefit from the exemption. **Provided that a fund is closed-ended and not substantially leveraged in accordance with the AIFMD framework, it should be able to benefit from the exemption from the proprietary trading ban.** This would cover all funds meeting the AIF definition, regardless of whether they are established in the EU or not. Allowing banks to invest only in some private equity funds but not in others would restrict the free movement of capital and risks discriminating against those funds which have substantially the same characteristics but are not marketed under the passport regime (for example non-EU funds that are only marketed in one Member State or non-EU funds that

[2] In particular Alternative Investment Fund Managers Directive (AIMFD), Capital Requirements Directive / Regulation (CRDIV/CRR) and Bank Recovery and Resolution Directive (BRRD)

[3] Article 111 of Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu


are managed by EU managers and are not marketed in the EU). We also feel that it would be unwise to force EU banks to invest only in EU assets. It is beneficial for banks to have different investment opportunities and invest in a pool of different funds that would help to ensure a proper diversification of their assets and hence lowering the risks they face.

One has to keep in mind that Articles 35 and 40 of the AIFMD as well as other provisions relating to the third country passport are not applicable yet. Their application depends on ESMA opinion that should be issued by 22 July 2015. However they only enter into force provided that ESMA advice is positive.

***Drafting suggestion***

***Article 6(3) – Prohibition of certain trading activities***

*3. The restrictions laid down in point (b) of paragraph 1 shall not apply with regard to closed-ended* ***~~and unleveraged~~*** *AIFs,* ***which are not substantially leveraged*** *as defined in the Directive 2011/61/EU* ***and Article 111 of the Regulation 231/2013*** ***~~where those AIFs are established in the Union or, if they are not established in the Union, they are marketed in the Union according to Articles 35 or 40 of Directive 2011/61/EU~~****, to qualifying venture capital funds as defined in Article 3(b) of Regulation (EU) No 345/2013, to qualifying social entrepreneurship funds as defined in Article 3(b) of Regulation (EU) No 346/2013, and to AIFs authorized as ELTIFs in accordance with Regulation (EU) No [XXX/XXXX].*

***Recital 17***

*(17) To ensure that the entities subject to the prohibition of proprietary trading can continue to contribute toward the financing of the economy, they should be allowed to invest in a closed list of funds. This exhaustive list should comprise closed-ended* ***~~and unleveraged~~*** *alternative investment funds (AIFs)* ***which are not substantially leveraged in accordance with the Directive 2011/61/EU and Regulation 231/2013****,* ***venture capital funds that fall under the definition foreseen in Article 3(b) of Regulation (EU) No 346/2013*** ***~~European Venture Capital Funds~~****, European Social Entrepreneurship Funds and European Long Term Investment Funds.* *~~To ensure that these funds do not endanger the viability and financial soundness of the credit institutions that invest in them, it is essential that closed-ended and unleveraged AIFs in which credit institutions can still invest are managed by AIF managers that are authorised and supervised in accordance with the relevant provisions of Directive 2011/61/EU of the European Parliament and of the Council, and that~~*

~~*those AIFs are established in the Union or, if they are not established in the Union, they are marketed in the Union according to the rules of that Directive.*~~ ***Given the contribution of venture capital funds toward the financing of the economy, in particular SMEs and the fact that EuVECA is an optional regime, credit institutions should be allowed to continue to invest in all type of venture capital funds. Therefore all venture capital funds that meet the definition of qualifying venture capital fund should be exempted from the proprietary trading ban.***

***Since all the funds mentioned above are regulated by the Union law, and since competent authorities are provided with different supervisory tools for monitoring and addressing risks associated with either funds' or managers' activities, investments in those types of funds do not endanger financial soundness of the credit institutions; therefore, credit institutions should be allowed to invest in such funds.***

### iii) Exemption for venture capital funds

Article 6(3) also provides an exemption for "qualifying venture capital funds" as defined in Article 3(b) of the EuVECA regulation. The Article is not clear on the precise scope of this exemption. There appear to be two interpretations: **1)** it is enough to meet the definition of qualifying venture capital funds as foreseen in the EuVECA regulation to be exempted from the proprietary trading ban; **2)** the venture capital fund needs to meet two criteria: i) fall under the definition of qualifying venture capital funds *and* ii) be managed by managers who have been authorised to use the designation EuVECA. Recital 17 implies that the latter is intended but we believe this would not be appropriate. Although we consider the EuVECA regulation as a very good initiative to improve access to finance for SMEs we do not see it justifiable to require venture capital funds to be EuVECA designated to qualify for the exemption. We are fully convinced that the exemption from the proprietary trading ban should also apply to venture capital funds that do not use the EuVECA label.

We have to keep in mind that EuVECA is an optional regime and requires fund managers to comply with additional criteria to be eligible to use the EuVECA label. There are many venture capital funds that operate only nationally and are either not interested in getting the EuVECA label or are simply unable to be

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu


EuVECA designated because of the nature of their business[4]. It is true that if venture capital funds wish to benefit from the exemption but they are unable to be EuVECA designated they can also opt-in to the AIFMD. However it is even more disproportionate to require those venture capital funds that are unable to meet the EuVECA criteria to have to "opt-in" to the AIFMD to be exempted from the ban.

Hence, we suggest amending recital 17 in such a way as to allow venture capital funds to be exempted from the proprietary trading ban, provided that they meet the definition of venture capital fund set out in the EU law.

***Drafting suggestion***

***Recital 17 – following sentence should be added***

***Given the contribution of venture capital funds toward the financing of the economy, in particular SMEs and the fact that EuVECA is an optional regime, credit institutions should be allowed to continue to invest in all type of venture capital funds. Therefore all venture capital funds that meet the definition of qualifying venture capital fund should be exempted from the proprietary trading ban.***

## III. Definition of lending

As we understand the intention of the proposal, it should reduce banks' risky activities while still having a positive impact on the financing of the real economy. Therefore, in order to avoid any unintended consequences and ensure that banks can continue to contribute to the financing of the economy, the definition of lending should not be narrowed down. Given the general objective to promote financing of the economy the definition of lending should be fully consistent with the current definition foreseen in CRDIV[5].

---

[4] There are currently only seven EuVECA funds registered on the ESMA database (http://www.esma.europa.eu/page/Venture-Capital-and-Social-Entrepreneurship-Funds) compared to 105 funds that were raising funds in 2013 (source: EVCAEVCA/PEREP_Analytics).

[5] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, Annex I, List of activities subject to mutual recognitio

***Drafting suggestion – Article 8 (1) (b)***

*(b) lending including, **inter alia:** consumer credit, credit agreements relating to immovable property, factoring with or without recourse, financing of commercial transactions (including forfeiting);*

## IV. Lending to private equity funds

The explanatory memorandum of the proposal says clearly, and very rightly, that private equity funds should be exempted from the proprietary trading ban. However lending to private equity and venture capital funds is enumerated as one of the bank's trading activities.

We do not see any justification to include lending to private equity funds among trading activities that should be subject to the separation requirement. We believe that such an approach would not only be discriminatory but it could also have a negative effect on the financing of the real economy. We consider such a solution to be inconsistent with the general objective to encourage the financing of the real economy, taking into account the important role private equity plays in providing growth capital to the European companies, SMEs in particular.

Borrowing at the fund level typically takes place on a short term basis for a few very specific purposes. Where the fund is waiting for investors to transfer a tranche of the capital that they have committed, a credit facility might be used as a short term bridge to enable an investment to be swiftly closed.

The borrowing facilities are agreed with the bank for the duration of the life of the fund, but the borrowing is typically limited in time and in amount. The capital committed by the investors is used to secure the borrowing. Since investors will have had to make a legally binding commitment to provide pre-determined levels of capital upon call by the fund manager, a loan of this type would be short-term.

The amounts borrowed at fund level for these purposes are therefore typically capped and secured for their duration against the legally-binding commitments of investors, and therefore do not create exposure at fund level. This exposure does not give rise to any concerns from a systemic risk or macro stability perspective and therefore such short-term lending, backed by the committed capital of investors, should not be prohibited from the deposit-taking entity.

Moreover, the CRDIV/CRR framework defines new prudential requirements for banks, not just in terms of capital but liquidity as well, placing banks under an obligation to calculate risk (including, credit risk, market risk, counterparty risk) for each type of exposure. All of these new requirements will contribute significantly to making banks safer and more stable and ensure that the risk that they take on (including all forms of lending) is matched with adequate capital protection.

As we saw during the financial crisis, the way in which banks fund themselves (an over-reliance on short term funding from the wholesale markets, for example) is perhaps more important to their overall risk profile than the nature of their assets. Appropriate risk weighting of those assets and the provision of adequate capital against them should ensure that banks are able to manage their exposure to different counterparties and to different types of lending.

The new capital regime has clearly put in place detailed regulation and supervision of any credit risk that a bank might be exposed to from the business it does with a private equity fund and the structure of banking proposal should also take that into account.

***Drafting suggestion - recital 17a should be added to the text***

***(17a) Having in mind that private equity and venture capital funds contribute to the financing of the real economy and that this positive role partly depends on the relationship of the private equity and venture capital industry with the banks (whether as investors, asset manager or lenders), bank's lending to private equity and venture capital funds should not be considered as trading activities and should not be subject to the structural separation.***

---

## Contact

For further information, please contact Anna Lekston at the European Private Equity & Venture Capital Association (EVCA).

Phone +32 2 715 00 33 Mobile +32 476 46 13 30

anna.lekston@evca.eu www.evca.eu

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

*About the PAE*

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

*About EVCA*

*The EVCA is the voice of European private equity.*

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

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

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

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

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

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