

Submission

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CREATING LASTING VALUE



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

13 May 2015

To: European Commission

Re: Response to the European Commission Green Paper
on Building a Capital Markets Union (COM/2015/063
final)

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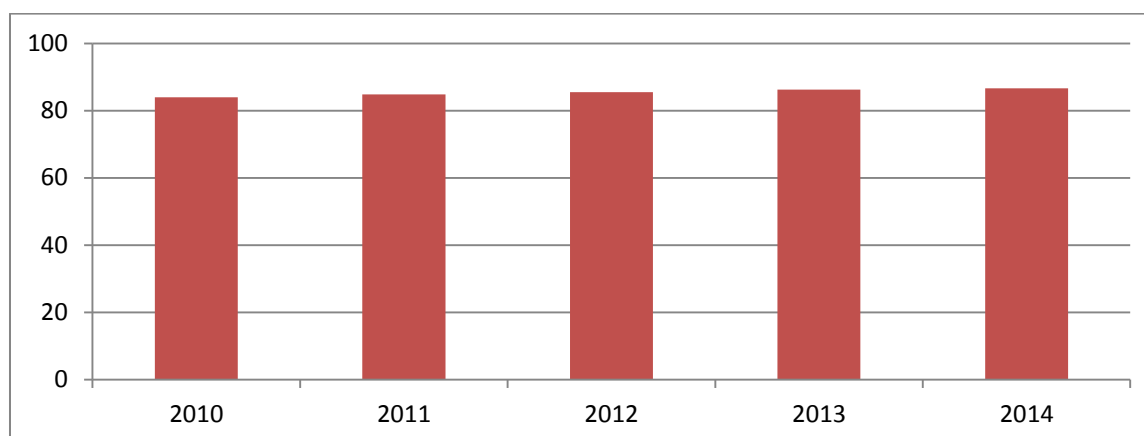
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The European Private Equity and Venture Capital Association (EVCA) is a member-based, non-profit trade association that was established in Brussels in 1983. The EVCA is a member of the Transparency register (ID: 60975211600-74).

Q1. Beyond the five priority areas identified for short term action, what other areas should be prioritised?

1. The overall approach of the Commission's Green Paper is welcomed by European private equity and venture capital fund managers and by those that invest in this asset class. The primary goals of a Capital Markets Union - to promote cross-border capital markets in Europe and to provide additional financing options for European businesses - are congruent with the essential features of private equity.
2. Private equity provides long-term financing for more than 5,000 European businesses each year, 86% of whom are SMEs, employing around 8 million people. It connects providers of capital from across the EU and beyond with businesses that are looking not only for equity investment but also for the operational guidance and assistance that a private equity manager can bring. It is this combination of *patient* capital and *active* management that characterizes the private equity model. Investments are held for an average of six years, enabling private equity to develop successful, sustainable companies. This makes it an attractive investment opportunity for pension funds or insurance companies looking for real returns and to better meet their long-term liabilities.



Private equity investment in SMEs (as a % of overall investment)¹

3. This partnership between investors, fund managers and investee companies is at the heart of private equity. The close alignment of interests between all three ensures a long-term perspective and a focus on developing successful companies that will continue to thrive after the company exits private equity ownership. Public policy has an essential impact on all parts of the private equity chain of investment, and while the regulatory, competition or tax framework under which private equity operates must promote financial stability and investor protection it must also operate in a manner that promotes appropriate risk-taking; that encourages entrepreneurs and investors to commit capital for the long term; and that provides the foundations for sustained economic growth.

¹ As companies over 250 employees (EVCA-PEREP data).



4. Capital Markets Union needs to be developed with these principles in mind: regulation should provide an appropriate framework for risk-taking; but not deny market participants the opportunity and freedom to take those risks without which innovation and growth will not materialize. Regulation can support but must not look to replace the legitimate interaction between investors and funds or between funds and companies that are at the heart of private sector entrepreneurialism.
5. The Green Paper is an important start to the CMU process. Although not all of the five initial priority areas will be directly relevant to private equity there is merit in each of them and they will make a positive early contribution to the further development of Europe's capital market.
6. The development of **private placement** markets and the review of the **Prospectus Directive** are the most important of these five actions for the private equity industry. The second proposed action - **Widening the investor base for SMEs** - also has merit. But this must not just be about improving the supply of *lending* (and in this regard we agree that improvements to the provision of credit information could be useful) but also about encouraging *equity* investment.
7. As the Commission reflects further on Capital Markets Union and how best to pursue it careful consideration must be given to the need for stakeholders to **absorb and adapt to new requirements**. For private equity there has not only been extensive new legislation impacting on fund managers but also major reforms to the requirements governing institutional investors. The cumulative impacts of such legislation, even on our industry, have still not yet been fully evaluated and it is essential that the Commission reflect on the impact any further changes would have.
8. Recognition of the important role played by **regulatory and legal certainty** is needed. Over the course of the last five or so years, the European Union has initiated a comprehensive programme of legislation, motivated - at least in part - by the need to address the weaknesses that the financial crisis had made so evident. For these businesses (many venture capital fund managers are themselves small businesses, employing no more than 10 or so people), such major legislative changes represent significant additional requirements. Adaptation to and compliance with new obligations represents both a direct financial cost and the opportunity cost of investor and fund manager time.
9. In pursuit of Capital Markets Union a top priority for the Commission must be to ensure that the opportunities presented by the **existing regulatory framework** are being fully realised. While some additional, targeted, legislative measures 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. This applies to both Level 2 measures and actions as well as to Level 1 legislation, where the consistency of the former with the latter is not always respected. Closer attention also needs to be paid to ensuring consistency *between* Level 1 measures, where conflicting or duplicate obligations or definitions that differ needlessly are too common.



10. Private equity and venture capital managers and investors have relevant, practical experience of how EU regulation impacts on their ability to operate across borders. The barriers and disincentives that many Member States have put in place in their implementation of the **Alternative Investment Fund Managers Directive (AIFMD)** and the **EU Venture Capital Funds Regulation (EuVECA)** are good examples of how the intentions of EU legislation to *remove* barriers to cross-border flows of capital may not be realised in practice.
11. In addition to reflecting on possible new measures the Commission must also be alive to the impact on Capital Markets Union that could come from a number of **legislative proposals that are currently under negotiation by the co-legislators** or by other bodies. It is essential that the Commission do all that it can to ensure that the Council of Ministers, the European Parliament and other rule-makers reflect the goals of CMU in their deliberations.
12. The **Banking Structure Regulation** must ensure that banks can continue to support private equity and venture capital funds and the companies those funds back, both as potential equity investors in such funds and through the provision of lending and other banking services. The current review of the **Shareholder Rights' Directive** risks imposing additional requirements on institutional investors and asset managers that go beyond sectorial legislation such as AIFMD, which has itself only just entered into force. The European Banking Authority's work on **Shadow Banking** risks mischaracterizing private equity funds as shadow banks and impeding their relationship with banks. While the **OECD** work on **international tax standards** risks imposing disproportionate compliance burdens on the very fund structures that are essential to mobilizing international capital to invest in European infrastructure and SMEs.
13. While there is much that can be achieved by setting the right regulatory, tax and competition policy environment the success of Capital Markets Union cannot be divorced from the broader regulatory and policy environment being pursued by the EU and its Member States. In a true Capital Markets Union, capital would be allocated across Europe - and beyond - without any meaningful differences across national borders: capital allocation would be 'location neutral'. An innovative start-up in one Member State should - all other things being equal - have access to the same level of capital and at the same cost as its equivalent in another.
14. But in practice, a range of different factors will continue to account for differences in the availability and pricing of finance, and not all of them will be capable of being addressed by the Commission's Capital Markets Union initiative or by DG FISMA. Rigidities in product or labour markets in one Member State compared to another may influence investor perception of the underlying risk profile of the company or of the rate of return that they can expect; the size of the domestic market in which the company will, at least initially, sell its goods or services may impact on revenues and profitability, certainly in those areas where the single market still has some way to go; as could underlying macro-economic conditions in the country and taxation regimes.



15. In short, Capital Markets Union has to be an initiative that is pursued consistently by the whole European Commission. Even with well-targeted specific interventions of the type set out in the Green Paper and in this response, CMU will not develop without continued (and sustained) efforts to deliver structural economic reform and an unyielding focus on actions that enhance the productivity and competitiveness of Europe's businesses.

Q3. What support can be given to ELTIFs to encourage their take up?

1. Ensuring sustainable and adequate long-term financing is an important component of CMU and **the creation of a framework for European Long-term Investment Funds** is to be welcomed. Private equity is already a substantial long-term investor in Europe and we support the Commission's ambition to highlight and promote ELTIFs to the wealth management industry.
2. As a first step it is important to make sure that the range of **Level II measures** that are required do not result in less flexibility for fund managers. In particular, the features of the schedule for the orderly disposal of ELTIF assets should not impose additional requirements on fund managers beyond those contained in the Level 1 text. Flexibility for divesting assets is imperative in order to ensure that managers are not forced into selling assets when the market value is low, thereby damaging investor returns and acting counter to the original purpose of establishing the ELTIF product. Furthermore, the rules that will determine when derivatives are being used solely for *"the purpose of hedging the risks inherent to the investments"* should equally ensure that the ELTIF manager has appropriate flexibility.
3. When it comes to the application of the Regulation in Member States the Commission will need to adopt a strong stance of **enforcement of the EU passport for marketing and investing across EU Member States**. Experience with both the Alternative Investment Fund Managers Directive and the European Venture Capital Funds Regulation indicates that many Member States are prepared to impose additional barriers to cross-border activity undertaken via a passport. Fees and charges imposed by host regulators and the introduction of other, regulatory, barriers such as requirements for local agents, go against the spirit and the letter of such single market legislation and impede the creation of a Capital Markets Union, acting as a disincentive for managers to operate across EU borders. We urge the Commission to be pre-emptive in its approach to this issue, making clear from the outset that Member States must not impose such barriers on ELTIF managers; and where such barriers are introduced the Commission and ESMA (and other ESAs as appropriate) should commit to acting swiftly and decisively to challenge them.
4. Although negotiations on the ELTIF Regulation have now concluded it is nonetheless appropriate to reiterate here some of the features that are likely to discourage take up.
5. **The barriers to entry for prospective fund managers seeking access to the ELTIF regime are too high**, i.e. full authorisation under the AIFMD, along with additional restrictions on eligible investments.



6. 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 Alternative Investment Fund (“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.
7. Alternative entry routes for prospective ELTIF managers should be considered for the future. This could take the form of an “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.
8. 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.”²
9. This alignment between the ELTIF and EuVECA frameworks should be further developed, in light of the similarities between the two, i.e. the focus on long-term, unlisted assets. The ELTIF Regulation would benefit when amended from allowing managers of EuVECA, as well as Alternative Investment Fund Managers, to become managers of ELTIFs. Allowing two routes to become an ELTIF Manager would allow smaller funds who are outside the scope of the AIFMD, but still required to meet certain standards set at EU level, to offer this product. Furthermore, it would promote diversity in ELTIFs as there will be a broader range of ELTIF Managers, adding to choice and competition. This is especially relevant since listed SMEs as well as unlisted SMEs are now included as eligible undertakings.
10. In attempting to attract both retail and professional investors into the same ELTIF, there is a risk of unwittingly discouraging the latter from investing in the proposed funds. If rules which are necessary for the protection of retail investors are also applied to professional investors, then ELTIFs may become less attractive for professional investors. There should be appropriate **differentiation between professional and retail investors**, notwithstanding the fact that the primary regime governing all ELTIF funds will be the same. The final ELTIF text did not strike the right balance in differentiating between different types of investor, not least because of the absence of an inclusion of the so-called “semi-professional investor” test as defined in EuVECA, Art 6.1.
11. While the classification of this type of investor (i.e. high-net worth individuals who are actively seeking these investment opportunities) in the retail investor category does not disallow them from investing in ELTIFs, there are disadvantages nevertheless. Under Article 23 of the ELTIF Regulation, where an ELTIF is intended to

² European Commission Proposal for a Regulation on European Long-term Investment Funds, 26 June 2013, page 3

be marketed to retail investors, that ELTIF needs to put in place facilities for making subscriptions, payments or redemptions in *each* Member State where it intends to market. This requirement for local facilities is no longer a practical necessity and runs counter to the encouragement of digital technology in other contexts.

12. There are also additional requirements for marketing to retail investors under Article 24 (such as the suitability test). On top of this, the presence of *retail* investors in an ELTIF will require the publication of a Key Investor Document (KID) under the (Packaged Retail Investment Products) PRIIPS Regulation.
13. It is therefore foreseeable that certain fund managers will only wish to incorporate an ELTIF which is aimed solely at professional investors (an option that is open to them under the ELTIF Regulation). In this instance, the absence of a semi-professional investor test will result in the exclusion of these investors from such funds.
14. There should be a full exemption for those ELTIF funds that are marketed *solely* to professional investors and to 'semi-professional' investors - as defined in Article 6.1 of the EuVECA Regulation (i.e. those that commit to invest at least EUR 100,000; and state in writing their understanding of the risks involved.) - from the requirements to draw up a KID or a Prospectus. A change to Article 23 of the ELTIF Regulation is very important to making the new regime attractive to professional and semi-professional investors. A Prospectus is not required for professional investors when they invest into other products, and so an obligation on ELTIF managers to produce one for this fund product will raise the cost of an ELTIF and, other things being equal, reduce its attractiveness.
15. It is disappointing that no **Alternative Investment Funds (AIFs) with similar long-term characteristics** to ELTIFs are regarded as eligible investments within this new regime. If AIFs were included, this would allow an ELTIF to invest a small amount of its capital in a private equity fund, an asset class with a proven long-term investment perspective. 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.
16. This provision also effectively precludes fund-of-funds managers from offering an ELTIF product. Unable to invest into AIFs, existing fund-of-fund managers with an established track record of offering investors the opportunity to access a range of long term-focused funds, are not permitted to offer an ELTIF product.

Q4. Is any action by the EU needed to support the development of private placement markets other than supporting market-led efforts to agree common standards?

1. The term "private placement" is used in a number of different contexts. The core use is for offers and placings of transferable securities which are exempt from the

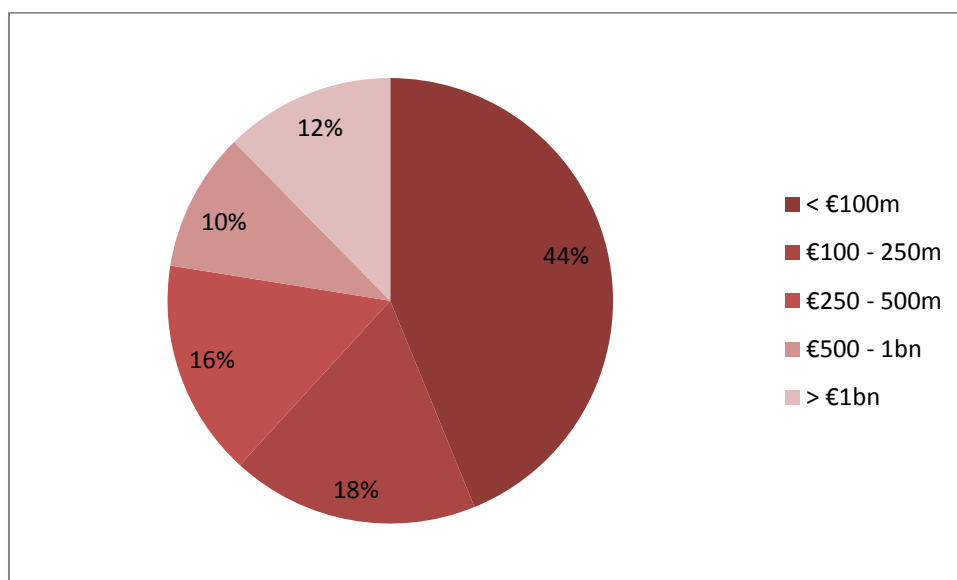


Prospectus Directive and therefore do not require registration or other interaction with regulators. In that context the review of the Prospectus Directive and appropriate extension of the exemptions is the most important action needed by the EU. It would normally be counterproductive to impose EU requirements in relation to placings conducted within those exemptions or do more than support market-led efforts to agree common standards in appropriate areas. We note that these may well vary depending on the type of instrument and market concerned. For example, the ICMA proposed common standards relate to debt issues which are privately placed for the most part in the financial sector.

2. Market-led efforts to agree on common standards are an appropriate way to proceed, providing those with direct experience the opportunity to identify issues and possible solutions. The speed and flexibility that such an approach can offer has advantages over a regulatory approach. But the Commission still has a role to play. It must monitor such efforts to ensure that they are genuinely open to all parts of the market that would be impacted. Market-led efforts must represent the whole market. And the Commission must also consider whether EU law would need to be adapted to facilitate market-led solutions: they will not be of value if provisions of EU law prevent their adoption or use.
3. In the context of private equity funds the AIFMD, and reporting under it, mean that **traditional private placements of interest in funds are no longer possible**. Interests in a fund can no longer be actively marketed (in contrast to the way interests in a commercial company can be actively marketed) without interaction with regulators within the scope of specific exemptions. Indeed the AIFMD places extensive and detailed requirements on fund raising from just the class of professional investors that are fully exempted from the Prospectus Directive. This demonstrates the very different private placement concepts under the Prospectus Directive and AIFMD.
4. The term “private placement” in the AIFMD context has therefore come to be used to cover those situations where Member State discretion permits the placing of funds in circumstances where EU-passported marketing under the AIFMD is not possible. These are no longer private placements in the traditional sense because interaction and registration with the regulators in each relevant Member State is required, together with mandatory investor disclosures and on-going reporting.
5. Nevertheless, national private placement regimes (NPPRs) of this kind continue to play an important role in private equity fund marketing in Europe, in the light of implementation of the AIFMD regime. The AIFMD passport is not available for those European fund managers whose assets fall below the AIFMD threshold and who do not opt to seek full-scale AIFMD authorisation; for European managers whose fund is outside the EU; nor for non-European fund managers. Developments in this area need to ensure that European investors can continue to access the best fund managers, wherever they are located and whatever their size. There are signs that in the light of AIFMD investors may not be getting this access³.

³ In a recent survey of institutional investors by the Institutional Limited Partners Association (ILPA) 85% of investors had seen a decrease in marketing by fund managers located outside Europe since AIFMD implementation.

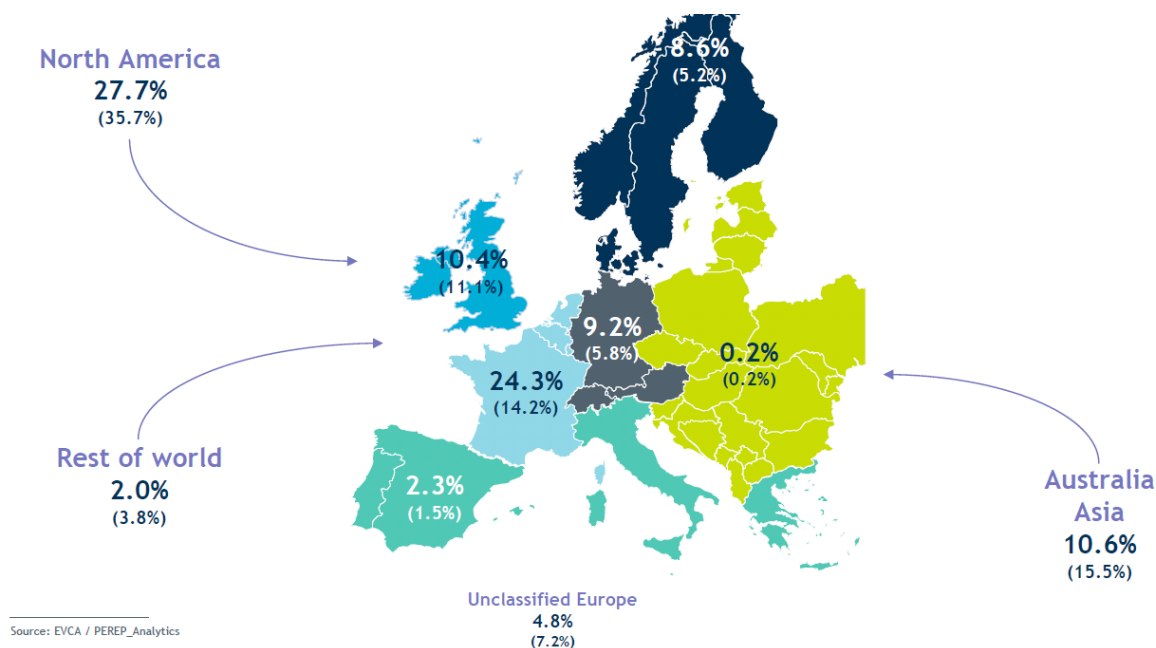
6. Private placement regimes in respect of fund interests have a particular importance for private equity and venture capital. **EU fund managers whose assets are below the EUR 500 million threshold** set in the AIFMD are not permitted to market their funds to institutional investors in another Member State via a passport without opting in to the full AIFMD regulatory regime. These requirements for full authorisation are extensive and risk imposing a barrier to entry and a reduction to investor returns, particularly if the costs cannot be spread across a high level of funds under management. As the chart below illustrates a large majority of European private equity funds (i.e. excluding venture capital funds) are comparatively small.



Number of private equity funds (exc. Venture Capital) by size (2014)

7. Although the EuVECA Regulation and its marketing passport is available for *some* of these smaller funds, many of them - including some that are clearly making venture capital investments - will not meet its particular eligibility criteria. For many 'below threshold' funds wanting to market in only a few Member States the cost of applying for the EuVECA nor EuSEF labels may not be justified. Private placement is therefore essential to enable smaller EU managers and EU institutional investors to be able to connect, enhancing investor choice and competition amongst managers.
8. A well-functioning private placement framework is a key part of Europe's financial regulatory architecture and necessary to ensuring the global capital flows that are at the heart of private equity. In the absence of a marketing passport EU investors also need to rely on private placement to be able to access **non-EU fund managers and EU fund managers with non-EU funds**. The private equity industry is inherently global: capital provided by investors in one jurisdiction is put to work by a fund manager in companies located in another. European companies want to be able to receive significant third country private equity investment; and European

institutional investors want to be able to invest in third country private equity funds (both for the returns they can offer and for the risk diversification benefits)⁴.



Private equity fund geographic fundraising breakdown in 2014 (2013)

9. Even once a third country marketing passport is available national private placement regimes should be preserved, to provide fund managers and investors with options. This is especially important to managers wanting to market only in a few Member States for whom having to apply for full authorisation in order to obtain the passport would impose disproportionate costs.
10. Some non-EU managers will no doubt choose to use the passport (if the arrangements for identification of a Member State or Reference can be made workable and proportional). But other fund managers - especially those with few existing European investors - may simply decide to by-pass European investors completely, instead concentrating their fundraising in other parts of the world. The alternative - requiring their entire fund and management structure and by implication their global investors - to become subject to AIFMD may not be attractive.
11. In such a scenario the primary impact will be felt by European investors, for whom the universe of available investment opportunities will have been reduced, limiting their choice, constraining their opportunities to diversify and reduce risk and - critically - hampering their ability to invest in those funds that they believe provide

⁴ According to a recent ILPA survey most institutional investors in Europe (78%) have selected more than half of their private equity managers from outside Europe.

the best potential for returns. This puts European investors at a potential disadvantage to their competitors in other regions⁵. A Capital Markets Union in which the best performing fund managers have turned their back on European investors and in which only those non-EU managers that are struggling with fundraising decide to come to Europe and to comply in full with AIFMD would not be a step forward.

12. Even if it may not be likely, one cannot rule out the risk of some form of retaliatory action by third countries, restricting EU managers from marketing their funds to investors in those jurisdictions. With 40.3% of the capital raised by the European private equity industry coming from outside the EU impediments to marketing would have a significant impact on private equity and venture capital managers' capacity to continue to invest in European SMEs.
13. That the maintenance of private placement as an option for fund managers is a key component of the continued health of European private equity and venture capital is therefore clear. But existing private placement regimes have weaknesses and can be improved. The complexity of 28 individual private placement regimes where they are available (some Member States have simply prohibited them) raises the costs of doing business in Europe.
14. Consistent with a preference for market-led approaches and recognising that under AIFMD private placement is an issue for Member States, there is nonetheless scope for some '**soft harmonisation**' in certain areas. Member States should work with the industry to develop a consensus around certain concepts that are part of all private placement regimes.
15. Among the key issues that AIFMs seeking to use private placement are facing are:
 - variety in the conditions that Member States impose and which must be met for private placement to be permitted, such as the requirement in Denmark for letters assuring reciprocity of market access;
 - variety in the registration processes that Member States impose: these differences impose costs for market participants for no appreciable benefit;
 - insufficient priority given by many national supervisors to the processing of applications, which introduces significant delays to fundraising. This in turn has consequences for the speed with which funds can begin the process of investing - the longer it takes to fundraise the longer it will be before the capital can be invested in the SME;
 - different interpretations and thus implementation of the AIFMD. For example, differences between the expectations of Member State competent authorities about the approach to certain of the pre-investment transparency obligations required under Article 23 AIFMD, and minor variations in the data fields

⁵ According to a recent ILPA survey 68% of institutional investors felt AIFMD left them at a competitive disadvantage

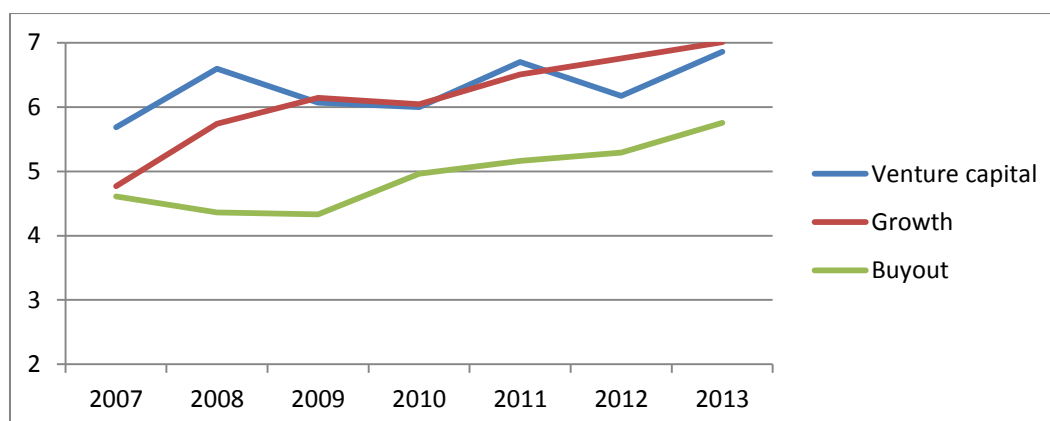
required to be completed as part of reporting on the activities of funds under Article 24 AIFMD.

Q5. What further measures could help to increase access to funding and channeling of funds to those who need them?

1. All investors into businesses experience barriers to or costs associated with the allocation of their capital. The decision-making process takes time and resources are required for appropriate due diligence to be undertaken on the various assets available in the marketplace. These **transaction costs** can represent a meaningful barrier to the flow of capital and in particular to investment across borders or in new sectors of the economy where those costs are (or can appear to be) higher. The need to overcome these transaction costs is likely to increase as savings and asset and wealth management become more institutionalized, not least as individuals take on an increasing responsibility for the provision of their own retirement income.
2. For investments into smaller companies - particularly those that are innovative and represent the highest potential in growth and job creation - these transaction costs can be particularly high relative to the anticipated risk-adjusted rate of return that an investor might expect. When compounded by regulatory requirements (which, for example, set specific liquidity requirements or impose additional prudential capital requirements on investments in long-term, illiquid, alternative assets), this can lead to a significant barrier to the flow of capital, and as a consequence, to unduly limited access to funding for those who need it.
3. Facilitating **access to public markets** by such companies is part of the solution, but will not be appropriate for all companies in all circumstances, necessitating a range of alternative sources of finance. **Private equity, including venture capital, fund managers** have a particular role to play in providing finance to those companies - particularly SMEs - that can benefit from patient equity investment and active ownership. These managers form part of an integrated market for capital that has national, European and global dimensions. They act as aggregators of capital, bringing capital from a wide range of investors together in a single fund to invest in European companies. Around 40% of the capital that European private equity managers have for investment comes from outside the EU, raised from institutional investors such as pension or sovereign wealth funds who see the potential in European companies but lack the expertise or resources to identify those specific companies that merit investment.
4. The involvement of the fund manager effectively **lowers the transaction cost** for the global investor: the experienced fund manager, with knowledge of the market and a track record of investing in companies in a particular sector, or with particular characteristics, undertakes due diligence that would not be possible (or at least not cost-effective) for the institutional investor. Moreover, the universe of potential investment opportunities is not neatly defined, as is the case for investors in public equity markets; finding companies in which potential investments could be made is

an expensive and time-consuming activity. It can take many years of patient investigation and discussion before an investment in a company is concluded. For each company in which an investment *is* made, as many as a hundred companies may have been considered, reviewed and been the subject of some degree of due diligence.

5. The capital that private equity offers to a company is at the same time both patient and active. While private equity managers are not looking for perpetual ownership of the portfolio companies into which they invest they are nonetheless long-term investors, providing equity investment for 6 years (on average). The capital they bring is also, critically, human as well as financial. They take on - as part of their agreement with their investors - a “hands-on ownership role” through their board participation, helping to bring in appropriate operational expertise, offering strategic advice and direction, and using industry and sector knowledge to help management develop the company.



Average length of an investment in years⁶

6. Ensuring that regulation is appropriate and tailored to the fund manager would provide institutional investors with a wider range of opportunities; free up capital for investment into European businesses seeking that investment; *and* ensure that fund managers were able to devote more time to their operational and strategic roles: being active investors and strategic board members in the companies in which they have invested and helping them to develop. Whether they are based in the EU or are third country managers with EU investors in their funds, private equity fund managers are subject to complex regulatory requirements, which do not seem to be justified by the systemic risk profile of the sector. With no systemic risk implications and an investor base that is professional / institutional in nature there is a strong case for arguing that these fund managers face a regulatory burden that is not proportionate to the risks they pose.
7. Private equity managers have an important role to play in lowering the transaction costs that institutional investors might face in directly accessing SMEs in which they

⁶ EVCA data

would like to invest. But those costs can be lowered further, by helping SMEs to improve their understanding of the different options available to them.

8. For many SMEs a bank is - and will remain for the foreseeable future - their first point of entry for a discussion of their financing needs. Banks therefore have a key role to play not only as providers of finance directly⁷ but also as the first 'touch point' for many SMEs that have exhausted internal sources of funding ('friends and family') and are now looking to bring in external finance. Although some banks do refer SMEs whose credit applications have been rejected to alternative finance providers⁸, there is no evidence that this happens systematically (in many cases, no doubt, due to the lack of awareness regarding the existence or potential benefits of these alternatives).
9. Banks should therefore commit to provide better information about alternative sources of finance and proactively take on a broader advisory role with businesses that approach them (and not only with those to whom they have declined to offer credit, which risks adverse selection). This is at least as important as encouraging the sharing of credit information with alternative providers of finance. Such initiatives should not need the support of EU policy and are capable of being entirely industry-led, but the support of the European Commission would be welcome and such initiatives could usefully be integrated into efforts and platforms for SMEs such as the Enterprise Europe Network, Your Business and the SME Internationalisation portal.

Q10. What policy measures could incentivise institutional investors to raise and invest larger amounts and in a broader range of assets?

Prudential Capital Requirements

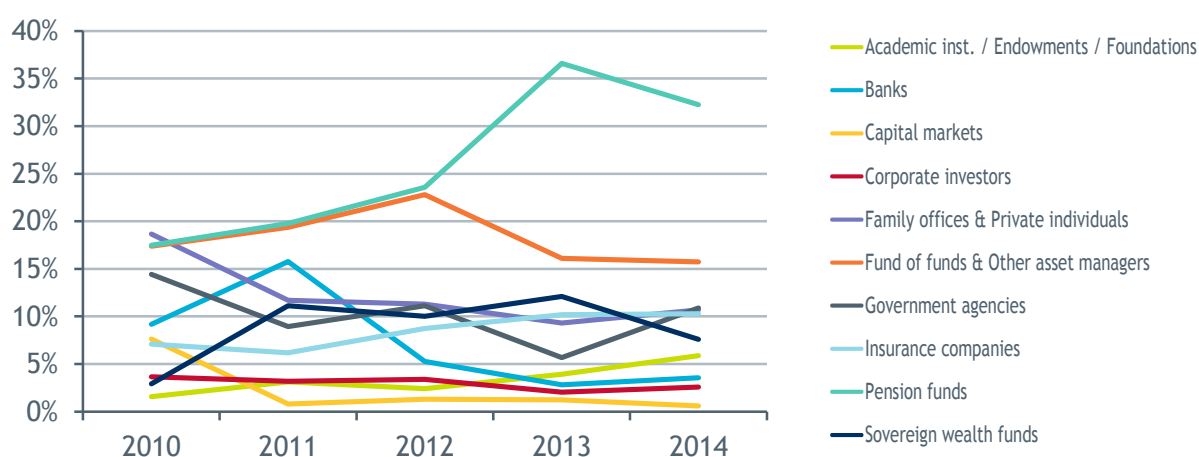
1. The perception of long-term, illiquid assets in prudential regulation remains negative. By their nature many long-term investments are illiquid and therefore will not have a daily observable market price. Too often these characteristics are deemed by regulators to signify inherently higher risk and therefore inherently less suitable forms of investment 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".
2. Policymakers at EU level and internationally need to place greater emphasis on understanding long term asset classes, the real nature of the risks that they pose, and 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. As long as prudential regulatory policy for such asset classes continues to be developed according to models that were created for liquid assets that are traded frequently there is a significant risk that the policy framework will not incentivise

⁷ [Commission Analytical Report](#)

⁸ [ECB Survey](#) on the access to finance of enterprises in the Euro area, November 2014

institutional investors to commit larger amounts to the projects and companies referred to in this question. Indeed, it may very well discourage these investors.

3. While there are numerous short-term initiatives that can be pursued to promote such investment (and there are many set out in this response) Capital Markets Union should also look to the longer term, setting a policy framework that will endure and will make an appreciable difference to the investment landscape in Europe beyond the mandate of this Commission. One key deliverable should be the initiation of a **programme of credible independent research** - preferably in coordination with international partners - into the characteristics of long term, illiquid asset classes. Investors already have extensive experience of investing into such assets and have developed their own models and approaches to assess and manage these risks. But a comprehensive programme of research should help to provide both regulators and market participants with an independent assessment of these models and how they can be incorporated into regulatory regimes.
4. Such prudential requirements matter and do impact the investment decisions that institutions make. The graph below illustrates the trends in institutional investment in private equity in recent years. While there are many factors that shape asset allocation decisions regulation can act as a disincentive, potentially deterring professional investors from committing capital to long-term assets, including private equity. More positively, the *right* regime will encourage this capital to be put to productive use, as US experience shows⁹.



All Private Equity: Incremental Amounts Raised During the Year (% of Total)¹⁰

5. And institutional investor capital *could* be unlocked for private equity. Over the last three years (2011-13) pension funds in Germany constituted 11%¹¹ of the overall private equity fundraising in the country. But this amounted to only around 0.3% of

⁹ Changes to the US ERISA (Employee Retirement Income Security Act) regime have facilitated pension fund investment into private equity and venture capital

¹⁰ EVCA/PEREP data, 2014

¹¹ EVCA/PEREP data, 2014



total allocations by German pension funds¹². If these funds had instead invested 1% (rather than 0.3%) an additional €1.63 billion would have been raised in Germany alone, providing fund managers with the capital to support many hundreds of additional companies.

6. The treatment of AIFs under the proposal on Bank Structural Reform; EIOPA's work on a new regulatory framework for IORPs; and the EBA's recent proposal that all alternative investment funds including private equity or venture capital funds should be treated as shadow banking entities could all have negative implications for professional investors' willingness and ability to invest in this asset class.
7. As the response to Question 5 demonstrates, most institutional investors use funds to be able to put their capital to use. While some such investors have the scale and resources to invest directly in infrastructure, or even in some cases directly into small companies, most are unable to do so and do not do so because of their consideration of the risks involved. Smaller and more innovative companies can therefore *only* access the significant assets held under management by these institutional investors through the use of an intermediary¹³. The regulatory environment - and particularly prudential capital requirements - plays an essential role in this process.
8. The discussion on Solvency II provides a very good example of the influence that such investor regulation can have and of the weakness of an approach to long-term assets that is founded on a methodology designed for liquid assets. While the 39% risk weighting for insurers' investments into private equity and venture capital was a welcome improvement from EIOPA's original proposal, significant concerns remain that this does not reflect the risk insurers face when investing in our asset class and may act as an artificial barrier to their investments.
9. Throughout the discussions on Solvency II the private equity industry 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*. 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 risk weight lower than 39%.
10. In May 2012 the EVCA produced a Research Paper, which was then shared with the Commission, on "Calibration of Risk and Correlation in Private Equity", which 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.
11. The EVCA carried out additional analysis and in October 2013, presented to EIOPA and the Commission another Research Paper "Calibration of Risk and Correlation in Private Equity Based on the LPX 50 NAV Index". This analysis sought to use other

¹²OECD Statistics, 2010-2012

¹³ See response to Question 14.



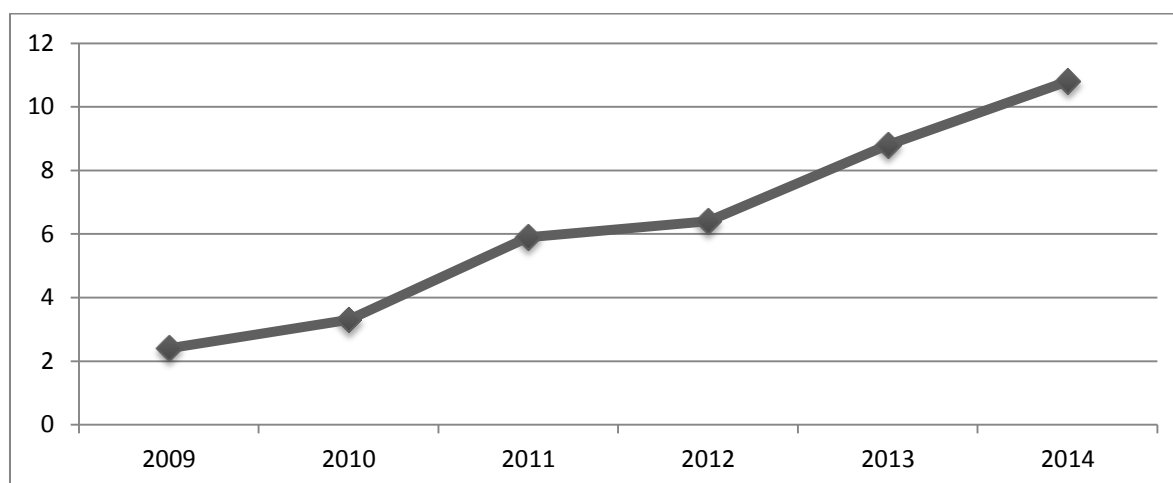
indices produced by the LPX group in order to satisfy the supervisory appetite for 'third party' data and for a 'market consistent approach' to be used to calculate risk weightings. Although some way short of what industry practitioners would regard as an appropriate measure, this work nevertheless provides a better proxy for the risk that insurers actually face than the LPX 50 TR used by EIOPA.

12. 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. Both indices also give a similar risk calibration: approximately 35%. This supports the original EVCA analysis of May 2012 that **the risk calibration for private equity funds in the standard formula should be in the range 20% - 35%.**
13. Given that Solvency II risk weightings are determined by a Level II Delegated Act (rather than being a feature of the Level I Directive itself), and given that there is already a need to revise this Act to cover insurers' investments into ELTIFs and into infrastructure, a ready opportunity exists to revisit the risk weighting for private equity and venture capital. A lower risk weighting would release significant additional capital for investment into European small businesses without being in any way inconsistent with prudential soundness.
14. EIOPA's on-going work on a new prudential framework for IORPD pension funds is also relevant in this regard. If this work were to lead ultimately to inappropriate capital requirements for pension funds the ability and willingness of this critical component of the investor base to commit capital, via fund managers, to smaller businesses would be impacted fundamentally. The Commission should ensure that work on the regulation of the pension fund sector promotes - rather than discourages - additional investment into private equity venture capital, and infrastructure funds, and thereby to European businesses.

Choice of Fund Manager

15. As the response to Question 5 illustrates, many institutional investors need to draw on the expertise of a fund manager in order to access and manage the opportunities presented by smaller companies. Without such an intermediary, the transaction costs associated with finding, making an equity investment in, and eventually divesting, such companies will be disproportionate. Few institutional investors will in addition have the resources needed to carry out the long-term, active ownership of the unlisted company that is at the heart of private equity's model of value creation.
16. Fund managers play a vital role in providing institutional investors with a means to access many of these less liquid and longer term assets, and the choice of managers with whom to invest is an essential decision. Institutional investors want the widest possible choice of managers and to be allowed to exercise their professional judgement in making this decision.

17. Regulation that impacts on fund managers and that governs or restricts the ability of fund managers and investors to connect will also influence the ability of those investors to access smaller businesses and start-ups. Investors want access to the best managers and to the managers who they feel provide the most appropriate fit with their risk appetite, strategy diversification, and return requirements.
18. Some of these top managers with whom European institutional investors want to invest (or their funds) may well not be based in the European Union, even if many of the companies into which they invest are. Investment in EU companies by private equity fund managers whose office is based outside Europe, has increased significantly over the last few years, demonstrating the ever-growing global nature of these capital flows.



Venture capital investment into European portfolio companies made by fund managers based outside Europe (% of overall investment)¹⁴

19. If regulation prevents European investors from accessing their preferred managers - as AIFMD seems to be doing¹⁵ - the investor faces a narrower range of investment choices. This reduces their potential to achieve the returns they need (an increasing issue for many European investors in a low yield environment¹⁶); and either causes them to adopt a less diversified portfolio (with risk implications); and/or simply pushes them away from making private equity and venture capital fund investments at all. An investor unable to access the fund manager it wants may simply exit the asset class entirely, rather than invest with a manager with whom it is not comfortable. Investors in smaller EU Member States may be particularly impacted as managers will tend to target their marketing on those jurisdictions where the high

¹⁴ EVCA data, location is the one of the office of the fund manager.

¹⁵ ILPA survey data indicates a large majority (85%) of institutional investors have seen decreased marketing activity by non-European managers

¹⁶ Private Equity consistently outperforms other asset classes (e.g. see ILPA Private Market Benchmark, September 2014)

costs of compliance can at least be justified by the presence of a sizable number of investors with significant capital to invest.

20. A regime that provides institutional investors with access to the best managers, in Europe or elsewhere, is therefore vital to ensuring that they will commit increasing amounts of capital through funds to less liquid assets.

Taxation

21. The tax system also has an impact on the relative attractiveness of investing via a fund structure. If an investor is penalised for investing through a fund this route becomes a less attractive option. Given that a fund is the only realistic means by which many institutional investors can invest in, for example, innovative start-ups (given the high costs of direct investment) a tax disincentive would have significant impacts.
22. With the fund structure and the fund manager playing an essential role in connecting institutional investors' capital with those hard-to-reach companies looking for finance it is vital that the tax system operates in a way that does not discriminate. An investor's decision whether to invest directly or via a fund structure should not be influenced by the tax implications of these two options. Such features as withholding tax regimes, the proposed Financial Transaction Tax, or work to reform tax treaties as part of the OECD's BEPS project can all prejudice investment via funds. The response to Question 30 covers these issues in greater detail.

Q11. What steps could be taken to reduce the costs to fund managers of setting up and marketing funds across the EU?

1. Many of the regulatory costs that fund managers currently face in Europe come from the AIFM Directive and although it entered into force in July 2011, with a deadline for transposition of July 2013, it remains difficult to assess fully its implications. With a one-year transition period, the Directive has effectively only been in operation for less than a year (i.e. since July 2014) in Member States that have completed their national transposition. Some countries have not yet fully transposed the Directive into national law.
2. The private equity industry operates over the long term with a typical fund having a ten-year life. Consequently, new funds are only raised every 3-5 years so many fund managers will not yet have experience of the full impact of the Directive on their operations (many will not yet have raised a new fund under the AIFMD). It therefore remains difficult to provide an authoritative assessment of the Directive's impact on the costs to fund managers of setting up and marketing funds across the EU. As the Commission considers the review of the Directive as mandated by Article 69 it will be essential that a full assessment of its impact is carried out before any conclusions are drawn.



3. Any amendment to AIFMD would generate additional uncertainty, which can itself impose costs. But it is clear even at this stage in the Directive's life that certain of its provisions impact adversely on fund establishment and marketing, i.e. capital raising and its application. Some of these issues (though not all) can be addressed, however, without amendment to the Level 1 text.

Impediments Faced by Smaller Fund Managers

4. Given their systemic risk profile and the recognition that the costs of compliance would be disproportionate the co-legislators agreed that it would not be appropriate to apply the full AIFMD regime to private equity and venture capital fund managers with assets below EUR 500mn. But while they are - appropriately - excluded from meeting many of the AIFMD's requirements many of these managers are also effectively excluded from the opportunity to raise funds from investors located in other Member States. Such a situation seems difficult to justify in a Capital Markets Union.
5. Only a small group of these smaller funds will qualify for the voluntary EuVECA passporting regime given its particular requirements, and so there are hundreds of fund managers who *either* have to opt in to the full AIFMD regime, *or* rely on national private placement regimes. Opting in to AIFMD is unlikely to be attractive for very many, given the costs that this will entail. And as some Member States do not allow smaller fund managers to make use of their national private placement regime (NPPR) to access investors this has the effect of denying these managers any means to operate across borders, contrary to the spirit of Capital Markets Union and arguably contrary to EU law. Where Member States' rules allow *domestic* smaller funds to market to institutional investors in their jurisdiction but not those from *other* EU Member States the negative consequences are particularly acute.
6. In a functioning Capital Markets Union such fund managers would be allowed the option to market in other Member States, whether through the extension of the voluntary EuVECA regime or through private placement regimes.

'Host' Member State Fees and Other Requirements

7. One of the most important steps which the EU could take in this area would be to prohibit the practice by some 'host' Member States of imposing additional fees and charges and/or additional requirements on EU fund managers looking to use their passport to market in that jurisdiction. Additional requirements include the obligation in France to appoint a paying agent for the fund, and 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. These additional costs are an impediment to cross-border marketing and are already causing some fund managers not to market in certain jurisdictions; the removal of such additional requirements would bring immediate advantages.
8. 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

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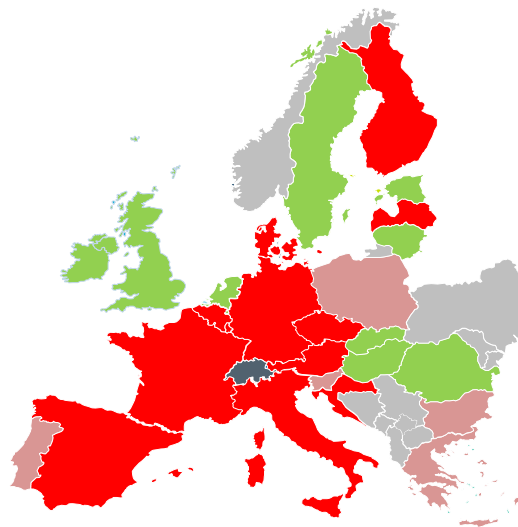
CREATING LASTING VALUE



restrictions and/or requirements to be imposed on the AIFM by the host Member State regulator. In a meaningful Capital Markets Union a fund manager that is fully compliant with the relevant EU law and that is in possession of a valid passport should be free to market across the EU.

AIFMD Host fees

Red = Country imposing a host fee
Green = Country not imposing a host fee
Orange = Unclear or Unknown



Streamlined Reporting

9. Streamlining the ‘**Article 42**’ notification process and subsequent periodic reporting requirements would also help to reduce costs. One of the key issues facing AIFMs seeking to use NPPRs is the absence of a harmonised ‘Article 42 registration process’ across the EU and varying conditions which must be met to satisfy national private placement regimes. There is a different form which must be filed with each Member State regulator and there are differences also 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 and the time period for the regulator to consider the application and the form/material submitted. The absence of a harmonised process means that AIFMs incur **considerable (duplication of) costs** in relation to any non-EU fund which is to be marketed across the EU as advice must be taken in each relevant jurisdiction and charges are incurred on a per-jurisdiction basis. This imposes de facto barriers to entry to their markets.
10. Similar issues arise in relation to the **periodic regulatory reports set in Annex IV of AIFMD** which must be filed with regulators post-registration. In this case, divergent national approaches to reporting (e.g. different reporting interfaces and technical structures) imply that fund managers are diverted from the core business, with no obvious benefit to financial stability or investor protection. The ability to register with, and report to, a single authority who could then share such information with Member State regulators (e.g. through ESMA) as deemed necessary would greatly reduce costs and complexity for fund managers.



Professional Client

11. Another limitation for fund managers comes from the definition of “**professional client**”. The “elective professional” element of this definition, set in MiFID but then adopted in both the Prospectus Directive and AIFMD, fails to take account of the specific characteristics of private equity, making it more complex and difficult for private equity fund managers to secure investment from a constituency of investors with genuine knowledge and expertise and who have a record of investing in the asset class.
12. The MiFID elective professional tests, when put into the private equity context, limit even further the number of professional investors because those tests are calibrated for MiFID investment services provided in relation to liquid assets such as traded shares (and are therefore much less appropriate for those investing in closed-ended relatively long-term funds). While institutional investors in private equity such as banks and insurance companies will fall directly into the definition of “professional investor” in Annex II of MiFID, “elective” professional clients, such as successful former entrepreneurs and/or family offices, must fulfil specific criteria which are not appropriately adapted to their investment approach, which may involve fewer but longer term investments.
13. To be so categorised as ‘elective’ professional clients such investors must satisfy two of the following three quantitative tests: (1) the client must have carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters; (2) the size of the client’s financial instrument portfolio, defined as including cash deposits and financial instruments, must exceed EUR 500,000; and (3) the client must work or have worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.
14. It is very difficult for many investors, even highly sophisticated investors, in a private equity context to satisfy two of these tests. Due to the long-term and illiquid nature of private equity investing test (1) is inherently discriminatory. Not even the most seasoned institutional investors make as many as 10 commitments per *quarter* to private equity fund managers. 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.
15. For the purposes of private equity and venture capital fund managers, the test should be amended to better reflect how investors invest in AIFs. We suggest either the amendment of limb (1) or the creation of a new category of ‘sophisticated’ investor, in respect of whom the passport would also be available. 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
16. More concretely, 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.

17. This would ensure the passport provides access to a larger investor base and might address some of the restrictions applying to non-professional investors in national legislation. For example in Finland, there are some restrictions relating to non-professionals, perhaps the most significant being that a sub-threshold AIFM may not market its AIFs to non-professionals (unless the Finnish FSA grants an exemption).
18. There would be additional benefits in future because the definition of “professional client” is often adopted by cross-reference into other legislation, with insufficient tailoring for private equity. For example, the PRIIPS Regulation currently looks set to require the production of a KID in respect of any collective investment undertaking where investment is open to retail investors, adopting the current MiFID definition of “retail”. One consequence of this is that private equity fund managers may be obliged to prepare and maintain a KID in respect of collective investment undertakings which pool co-investment by expert members of their own staff and close associates, such as chairmen of their portfolio companies. This is an additional burden without any meaningful benefit.

Depository

19. One of the most significant additional costs that fund managers now face comes from the requirement to appoint a depository. Given the nature of the assets into which private equity funds invest both fund managers and their investors (the supposed beneficiaries of the requirement) expressed significant reservations about the investor protection implications of such AIFMD obligations as the requirement to appoint a depository¹⁷.
20. Notwithstanding these doubts about the very obligation to appoint a depository (and institutional investors are clear that they see little or no benefit in such features of AIFMD), the costs that fund managers, and ultimately investors, bear are increased further by the absence of a passport for depositaries. In a Capital Markets Union there should not be an obligation to appoint a depository that is located in the *same* Member State as the manager; managers should be able to benefit from the efficiencies and other benefits that would flow from being able to choose freely from amongst depositaries located across the EU. In smaller Member States with few managers and/or funds the inefficiencies are particularly acute.
21. These costs are compounded by the AIFMD requirement for a manager to employ a depository in *each* Member State in which it has set up a fund, denying the manager the opportunity to achieve economies of scale by appointing a single depository. In a genuine Capital Markets Union such inefficiencies would surely be addressed.

¹⁷ In a recent survey of institutional investors carried out by the Institutional Limited Partners Association (ILPA) more than 50% felt that AIFMD had had either a ‘Somewhat Negative’ or ‘Extremely Negative’ impact on investor protection

Q12. Should work on the tailored treatment of infrastructure investments target certain clearly identifiable sub-classes of assets?

1. Given the positive role that infrastructure investments, including investments via infrastructure funds, can play in helping to boost growth and jobs in Europe, a specific standard formula treatment for infrastructure investments would ensure a more risk-sensitive treatment of the asset class.
2. Infrastructure investment takes a number of forms, including via funds that invest in the asset class, providing capital to infrastructure companies and assets and thereby funding energy, transport facilities, networks and other essentials.
3. Generally, infrastructure funds share many of the characteristics of private equity funds in terms of the fundamentals of the fund structure and the relationship between investors and fund managers. However, infrastructure funds will invest only in companies engaged in the operation of infrastructure and the provision of services in this area, and may also have an even longer investment horizon than traditional private equity funds, as they invest once the facility is up and running, producing a long term running yield for investors.
4. Infrastructure fund managers usually make equity investments in private, un-listed companies owning and operating infrastructure assets (typically during its operational phase), which offer strong, reliable, protected cash flows and significant opportunities for value creation. These can include gas and electricity networks, transport infrastructures such as toll roads, bridges, tunnels, railways, airports, ports and parking facilities as well as renewable energy assets.
5. The provision of infrastructure services requires *both* the construction of the physical assets *and* their subsequent operation. Separate economic entities may be responsible for each of these, but both are necessary for the end-user to be able to benefit from the *service* that is the ultimate purpose of the infrastructure in question. Investment in the operation of infrastructure can lead to a higher quality service, to more efficient use of the physical asset, and to cost savings. Any discussion about how to develop Europe's infrastructure, and the role of institutional investors such as insurance companies in this, needs to take account of these two dimensions and of the existence of a range of different financing options (including via fund structures) by which capital can be put to work.
6. Investors' exposure to infrastructure can therefore take many forms and we believe that any review of prudential rules should **not focus solely on direct investments** in infrastructure projects but should also take into account other investment vehicles, including infrastructure funds. Given that infrastructure investments that take place via fund structures play a similar ultimate role to direct infrastructure investments in providing services used by economic agents they should also be considered for specific treatment under CRD4/CRR and Solvency II framework.
7. Moreover, if it were decided that infrastructure funds should only fall under the definition of "infrastructure" currently determined for the purpose of Solvency II

framework, the market-consistent approach should not be limited to a pure mark-to-market valuation for this type of investments as this is not always appropriate, or indeed technically correct. It is necessary to ensure that a reasonable approach to valuing investment in infrastructure is taken within the framework of a market consistent approach.

Q14. Would changes to the EuVECA and EuSEF Regulations make it easier for larger EU fund managers to run these types of funds? What other changes if any should be made to increase the number of these types of fund?

1. A **tailored and proportionate** regime for smaller fund managers is essential and was a strong justification for the adoption of the EuVECA Regulation in 2013. A voluntary passport regime remains the right approach for such managers but changes could be made to the regime in order to increase its take-up.

Appropriate Implementation by Member States

2. As with implementation of the AIFMD (see the response to Question 11), ensuring that the EuVECA Regulation is applied consistently and appropriately across Member States must be the first step. Reducing incoherence and inconsistency will give smaller funds a better opportunity to make use of the EuVECA passport and to fundraise cross-border under this label by lowering the costs associated with it. The more requirements are added by Member States and the greater complexity these generate, the less attractive the regime will be for the small fund managers at whom this regime is aimed.
3. For example:
 - the obligation to fulfill CRR capital adequacy requirements in Germany;
 - the need to draw up a full application to the regulatory authority in Luxembourg;
 - a requirement to give “fit & proper” information; and
 - the imposition of passport fees and charges by certain host Member States.

Extending the Range of Eligible Funds

4. There is a strong case for reconsidering whether the narrow focus of the EuVECA regime is appropriate and for extending this voluntary regime to all fund managers whose assets under management are below the EUR 500 million threshold, regardless of whether they are venture capital, growth/expansion or small (sub-threshold) buy-out funds.
5. Limiting EuVECA only to venture capital funds that meet a specific set of fairly restrictive criteria automatically limits its potential take-up. It also implies a stark distinction between fund investment strategies that may not be helpful nor reflective



of the needs and the experiences of either the investors or companies which they are typically looking to finance through different stages of growth.

6. During their development smaller companies may be backed at different stages of their life by different types of funds. Funds with a 'Growth', 'Development' or buy-out strategy can play as important a role in the long-term success of a European SME as those with a 'Venture Capital' objective. A recent industry report showed that the probability of raising mid or late stage capital in Europe is *three times lower* than it is for early stage funding (compared to the US, where no such difference exists)¹⁸. This suggests that *later stage* fund investors into smaller companies may have an increasingly important contribution to make in Europe.
7. But such Growth, Development or small buy-out funds do not currently have access to an internal marketing passport unless they opt in to the full AIFMD (which is likely to be unduly burdensome for the type and size of fund they represent and not reflective of the actual (if any) systemic risk that they pose).
8. These small funds should be provided with a means to market across EU borders, as failure to do so undermines the objective to establish a single market for capital. Fund managers who do not need to be authorised under the AIFMD do not pose systemic risk (which is the justification for not requiring full AIFMD authorisation), are not likely to pose a higher degree of risk for investors than venture capital funds, and would still only enjoy a pan-EU passport to market to "professional investors" (and not to retail investors). Since development and growth finance, which is often also provided by a "buy-out" investor offering an exit to a founder, are just as important for the EU economy as start-up capital, the voluntary EuVECA regime could be extended to funds with this type of strategy.

Specific EuVECA Requirements

9. Even for funds that have a clear venture capital investment strategy and are therefore ostensibly the target audience for EuVECA the **qualifying investment requirements** can make it unattractive.
10. The requirement to invest 70% of fund commitments in qualifying investments may deter managers who invest in SMEs. At the start of the fundraising process - when the manager is considering an application to become an EuVECA - the manager may not be confident that they can *guarantee* finding the number of attractive qualifying investments that are necessary to stay within this limit during the life of the fund. No manager would want to run the risk of marketing a fund as an 'EuVECA' only to fail to comply with its requirements for legitimate reasons of portfolio selection. The risk that investors into the fund could seek legal recourse or use that as a legitimate reason to cancel their agreement to commit capital can be sufficient to discourage managers from pursuing EuVECA authorisation.
11. More concretely, 70% of an EuVECA fund's investments must be made into portfolio companies which are based in jurisdictions that have entered into a **Relevant Tax**

¹⁸ "Europe is your competitive advantage" – FranceDigitale, TechEU et al



- Agreement** with each EU Member State in which the fund will be marketed. However, some EU Member States have entered into few Relevant Tax Agreements (i.e. one that complies with the OECD Article 26 tax convention); or have agreements that do not meet the OECD standard.
12. A fund seeking to make significant investments in Switzerland, for example, could struggle to comply as the agreement between the UK (a major source of institutional capital) and Switzerland does not meet the relevant standard. And any fund looking to market to investors in Austria, Bulgaria, Croatia, Latvia, Luxembourg, the Netherlands or Romania - a quarter of the Member States - could face difficulties given the relatively small number of agreements they have in place.
 13. The requirement that **secured or unsecured loans** not exceed 30% of fund commitments precludes certain managers whose strategy may involve investing a higher proportion of debt alongside equity; or discourage those who are simply unwilling to deny themselves the flexibility to find the right mix of debt and equity as circumstances and market conditions dictate. Concentrations of loan notes alongside equity are not uncommon for earlier stage investment, helping to mitigate down-side risk and offering some protection for the fund should the portfolio company become insolvent. This threshold should ideally be removed, or at least increased.
 14. Such issues deter managers from making an EuVECA application. The application must be made right at the beginning of the manager's marketing and fundraising activities, a point in the fund's life when managers will often not have the level of clarity on where the portfolio companies into which they might invest will be based, or where their target investors will be based. For many the inability to determine with enough certainty whether this 70% obligation is achievable throughout the next ten or more years (the typical life of a fund) will be sufficient to discourage them from making an application.
 15. The **narrowness of the SME definition used in EuVECA** also raises issues, excluding companies that would be considered 'small or medium' sized by fund managers and investors. Companies active in the services field, for example, may fairly rapidly reach 250 employees but from a financing perspective are still 'early stage' and looking for equity backing from venture capital or other active fund investors. Furthermore, 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 corporate venture capital investment cannot 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
 16. Large fund managers tend to execute larger sized transactions, i.e. they look at and invest in companies that are larger than those defined by the EuVECA and EuSEF legislation. As a consequence, this legislation is not currently attractive to managers with large amounts of capital to invest. However, there are an increasing number of managers that have funds in the EUR 100-200 million bracket that do invest in early stage companies, although often those with more than 250 employees. It is this



aspect that is proving to be problematic and not the Turnover/Balance Sheet criteria. Against this background, the Commission may want to consider a review of the SME definition in relation to EuVECA, in particular whether the 250-employee limit should be raised, or whether a “two out of three” test could be appropriate.

17. Other suggestions for changes to the EuVECA Regulation include:

- Greater use of the concept of proportionality in particular in relation to smaller, start-up fund managers, would assist in reducing **the year 1 regulatory burden** (e.g. reporting).
- **Exclude EuVECA Assets Under Management (AUM) from the AIFMD threshold calculation**, so as to ensure that EuVECA AUM do not - on their own - trigger AIFMD registration. This would allow successful EuVECA firms to continue to grow AUM, which is likely to result in greater capital invested in EuVECA funds over time as the sector grows and matures.
- **Permit fund managers who are above the AIFMD threshold to also manage EuVECA funds.**
- **EuVECA funds should be exempted from the Prospectus Directive requirements** where these funds are marketed only to professional and “semi-professional” investors, i.e. those who invest a minimum of EUR 100,000 and understand the nature/risk of the investment, as defined in the EuVECA Regulation (Article 6.1). However, if EuVECA funds were to issue transferable securities to the public, it would then be crucial for these funds to be caught under the Prospectus Directive, in order to give retail investors the legal protection which they need.

18. But even with these changes it is important that smaller fund managers are left with options for how best to market their funds and to raise capital from investors. A voluntary EuVECA regime that provides an optional passport needs to sit **alongside a functioning and open private placement regime**. Smaller fund managers must not be forced to adopt one route or the other but given the freedom to choose that which best suits their specific needs.

Q15. How can the EU further develop private equity and venture capital as an alternative source of finance for the economy? In particular, what measures could boost the scale of venture capital funds and enhance the exit opportunities for venture capital investors?

1. Private equity activity has three components: **fundraising**, during which fund managers raise capital from investors; **investment**, during which the manager puts that capital to work, investing it into companies and working with them to develop the business; **exit**, the point at which the company is transferred to its next owner, providing a return for the investor, a proportion of which might then be committed to further private equity or venture capital investment. Barriers or hurdles that make

any one of these stages more difficult or costly can therefore act as a disincentive for European private equity and venture capital.

2. Some of these barriers arise from underlying features of the European economy and its investment landscape. For example, the absence of the type of large university endowments that have been such active investors into venture capital in the US may help to explain the smaller volume of fundraising in Europe; the cultural preference in Europe for entrepreneurs to seek financing through debt rather than equity¹⁹ may reduce the pool of companies prepared to accept private equity backing; and exit opportunities can be limited due to the size and liquidity of IPO markets in Europe.
3. Many of these factors are not related directly to capital markets and cannot be resolved by amendments to financial market policy. In order to deliver a Capital Markets Union EU policy needs to be considered as a coherent whole, with all parts of the Commission oriented towards that objective. An insufficiently integrated single market with divergent copyright, environmental or other technical rules may effectively prevent start-ups in cutting-edge technologies from operating on a cross-border basis and from accessing the full market that Europe offers. While financial market regulatory policy is likely to be at the core of this exercise CMU will only be realised if policies on structural economic reform; on tax; on competition; on public procurement; and on EU budget expenditure are all oriented towards this end.

Facilitating fundraising

4. As we explained in our response to Question 10, there is an extensive network of EU regulatory measures that apply to institutional investors, often designed to ensure the prudential soundness of the institution and to ensure financial stability. But legislation such as Solvency II, CRD IV / CRR or IORPD will also have a major impact on the investment decisions of those investors. In effect it shapes their willingness to act as suppliers of capital to particular asset types: prudential capital charges, for example, effectively change the anticipated net return to the investor from a particular investment.
5. Much of this legislation is now settled and a wholesale reopening of the *acquis communautaire* in these areas is not appropriate, not least because the additional uncertainty that this would create is likely to further impede flows of capital. But the Commission - working with the three European Supervisory Authorities - should initiate a programme of research into the appropriate way to determine capital and other requirements for investors into long-term asset classes.
6. The Solvency II experience has demonstrated serious difficulties in applying a 'market-consistent' approach to the determination of the risk associated with long-term asset classes, overstating in our view the risk that institutional investors face from such assets and thereby discouraging the commitment of capital to them.
7. But where changes can be made easily (for example to the Solvency II Delegated Acts) or where further Level 1 legislation is necessary for other reasons (for example

¹⁹ Survey on the Access to Finance of Enterprises (SAFE), European Commission, November 2014

amendments to CRD/CRR to implement further recommendations from the Basel Committee) prudential capital requirements should be amended to promote rather than discourage the commitment of capital to private equity and venture capital funds, and through them to European businesses.

Investment rules

8. Private equity fund managers attract capital from institutional investors through their own marketing activities, or as a result of being approached directly by investors. Investors need access to the best investment opportunities, whether in Europe or in other markets.
9. The legislative framework at national and EU level has a significant impact on the ability of this model to function smoothly. There are three particular features that should form part of a Capital Markets Union: overcoming barriers to use of the existing AIFMD and EuVECA passports; ensuring national private placement regimes (NPPRs) can continue to be used, especially by funds that are not able to use the passport or for whom it is not suitable; and the establishment of an AIFMD third country passport regime that promotes competition and investor choice.
10. State aid rules also have a part to play in promoting venture capital. The recently-adopted amendments to the regime could be further improved to create a more favourable environment for the sector's development. Two measures in particular could help the development of European venture capital:
 - an extension of the scope of the General Block Exemption Regulation (GBER) to the risk finance of start-ups and innovative SMEs; mechanisms similar to the one provided in the 2014 GBER for aid to start-up could also be applied to innovative SMEs, who often face a significant financing gap;
 - the GBER provided that the total amount of risk finance that may be awarded to an eligible undertaking in principles cannot exceed EUR 15 million. But this is currently assessed without any time limitation, which means that all aid granted via a risk finance measure under the GBER or the Risk Finance Guidelines is counted towards this threshold over time, until the risk finance resources are used up. For innovative, high growth potential start ups or SMEs this limit may not be sufficient as over its life more support than EUR 15 million may be needed to enable it to grow to its full potential. A 'reset' could therefore be envisaged (e.g. after three years) to allow further investments to be made.

Legislation Impacting on Exit

11. The point at which the private equity backed company is transferred to its next owner or owners, is the point at which a return on that investment is realised. Private equity fund managers therefore see exit as an integral part of the overall fund strategy.



12. There are three main exit routes:

- selling to another private equity company (for example, a venture capital fund manager selling to a growth fund that will be able to allow the firms to access new markets);
- selling to another business (for example, a start-up in the IT space sold to an established corporate) ; and
- public listing via an IPO.

13. Of these routes it is the third that is most likely to be directly affected by EU policy (although factors such as EU competition policy or company law requirements may impact all three). Because of concerns about the long-term health of Europe's IPO markets the private equity industry was a contributor to the IPO Task Force, chaired by Philippe de Backer MEP. This group carried out extensive work on the issues affecting the European IPO market, and published its conclusions on 23 March 2015.

14. The Task Force made a series of recommendations based on its analysis of those factors that impact the 'supply' of IPOs (i.e. the number of companies interested in listing) and the 'demand' (investor appetite for newly listed companies). Implementation of these recommendations would make a valuable contribution to the health of private equity in Europe, by ensuring a key exit route is available.

Venture capital

15. A regulatory and tax regime that encourages capital to be committed to funds and that facilitates fund managers to invest in European businesses is vital for the growth of European private equity and venture capital.

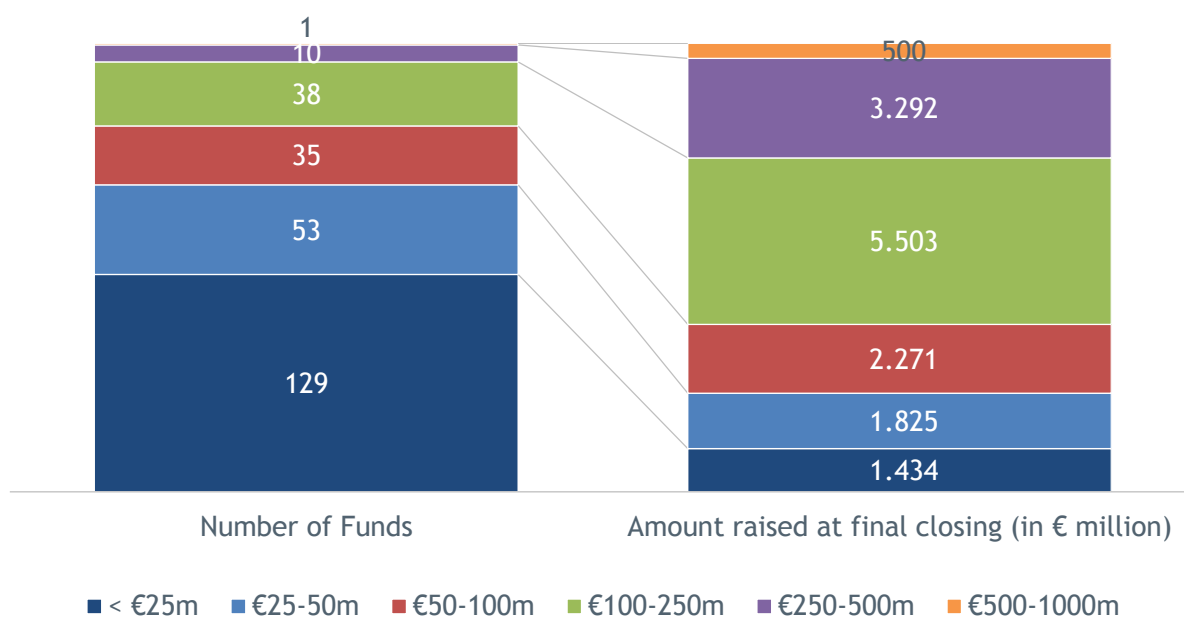
16. But European venture capital also faces some specific challenges that are unlikely to be entirely addressed by resolving such issues as Solvency II or CRD/CRR risk weightings or addressing the issues generated by AIFMD and EuVECA (even if they will make an important contribution).

Achieving Scale in European Venture Capital

17. Too few European venture capital funds currently have the scale needed to be a viable investment option for large, global institutional investors. During 2009-14 only 49 venture capital funds (or 20% of those achieving a closing) raised more than EUR 100 million; and the average European venture capital fund is only around EUR 60 million.

18. Such funds are too small to interest many institutional investors, whose minimum investment will tend to be measured in the tens of millions (or larger in some cases). Smaller investments are often simply not viable for these investors, given that the costs of manager selection, due diligence and portfolio management are likely to be no lower for a small investment than for something much larger. It is also unviable due to investors' consideration of risk mitigation and the level of exposure to any single fund: to be able to invest an amount that is consistent with the diversification

requirements of the investor's strategy, means that for many investors the level of exposure to a single fund this would give rise to, when the fund is very small, would present an unacceptable level of concentration risk.



VC Funds with final closing 2009-2014 - size of funds²⁰

19. Even if these investors have an interest in accessing innovative European start-ups via venture capital there are too few funds of sufficient scale to be able to absorb their capital. Whereas private equity funds in Europe are able to attract these increasingly important international pools of capital, venture capital is lagging behind²¹.
20. Improved returns from European venture capital have a part to play in bringing investors back, and there are encouraging signs that these are now being achieved: top-quarter performers over the period 2009-13 returned over 18%²², with indications that these returns are being maintained (and bettered). But improved returns will take time to feed through into increased capital commitments from investors, and there is no guarantee that they will respond. Those that exited venture capital completely over the last decade may find it difficult to re-enter the asset class quickly if their own expertise in the sector has been lost or redeployed.

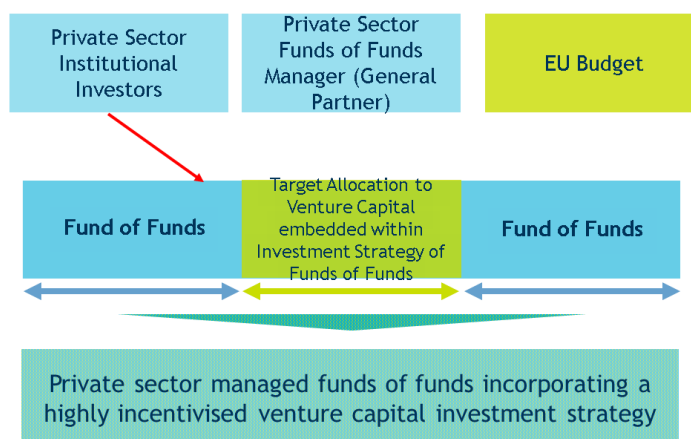
²⁰ EVCA/PEREP

²¹ In 2014 buyout funds raised 48% of their funds from outside the EU; venture capital funds 11%

²² EVCA Pan-European Private Equity Performance Benchmark Survey

21. Action needs to be taken, therefore, to generate a greater number of opportunities in European venture capital that global institutional investors could access, to complement regulatory or tax reforms. A **public-private fund-of-funds programme** would help to address this. An EU budget contribution would be used to provide cornerstone public investment in a series of venture capital-oriented funds-of-funds, with this EU capital (at minimum) matched by private money that the fund manager would be mandated to raise. EU funding would act as a genuine catalyst for private sector investment, by providing a vehicle of appropriate scale and through design features that offer incentives (e.g. a cap on the public sector's return, providing an upside incentive for private investors). Although the insertion of a fund-of-funds layer brings some additional cost this can be justified by the **access to larger pools of international capital** that it would bring. A more detailed explanation of how this scheme would work can be found [here](#).

Structure of the proposed fund-of-funds

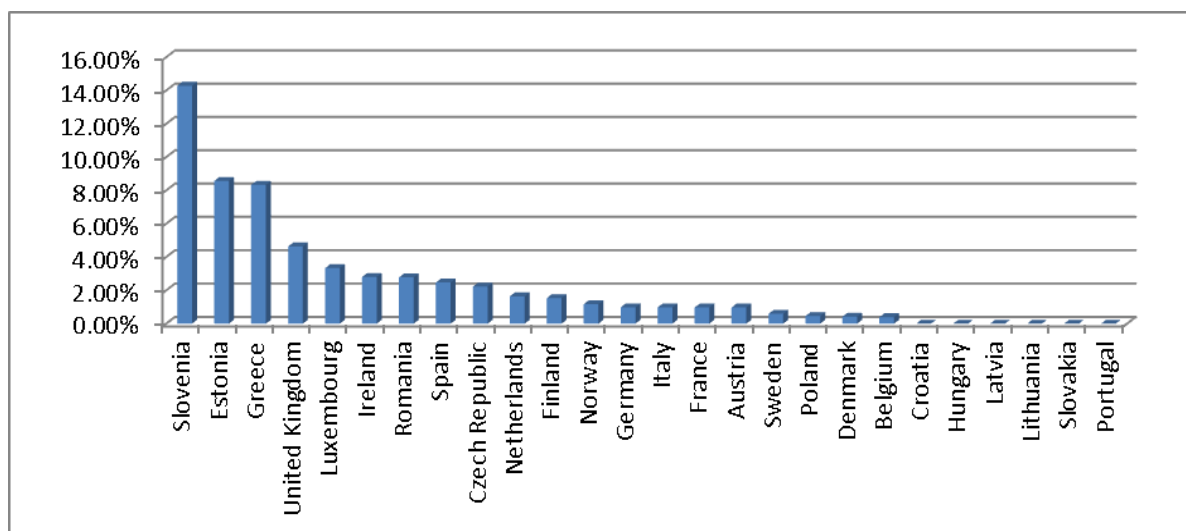


Q22. What measures can be taken to facilitate the access of EU firms to investors and capital markets in third countries?

1. The private equity industry is intrinsically global, with funds being raised from investors across the world and invested by managers in portfolio companies in Europe and beyond. Free movement of capital on a global basis (both into and out of the EU) is important both for portfolio companies based in Europe, which are the recipients of significant third country private equity investment, and for European institutional investors, who invest in third country private equity funds as part of their asset allocation and risk diversification strategies.
2. 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. At the same time, 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, as shown in our response to Question 10, point 18). 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.

3. European policy should encourage those non-EU managers to remain active in Europe, both in their fundraising and their investment into portfolio companies. Although AIFMD deals primarily with the marketing of funds rather than with investment, it nonetheless helps to set the tone, sending signals about Europe's openness to private equity investment. Except in some very small markets, there is never more than 5% of companies receiving funding from non-European fund managers.



Companies receiving private equity investment from managers based outside Europe as a percentage of all private equity-backed companies located in the country²³

4. A global industry needs global rules, or, at the very least, mutual recognition between the different legislative systems in developed economies. The Capital Markets Union should have a global as well as a European dimension. It must facilitate flows of capital *within* Europe but also open the European market to the *rest of the world* increasing the flow of capital from third country markets to Europe and from Europe to third country markets.
5. Progress made by the European Commission in global forums such as the G20, FSB, IOSCO or the OECD to set international standards is therefore to be supported. But these standards have to be carefully drafted and must not work against cross-border fund structures, which is a risk for example with the global tax agenda. Stronger cooperation between national regulators, such as the Financial Markets Regulatory Dialogue (FMRD) process between the European Union and the United States, is also to

²³ EVCA data, 2013 (NB: location of the manager being the location of the office advising the investment)

be welcomed. But greater effort should be made to involve stakeholders in these Dialogues in a structured way. Market participants will have a valuable perspective to offer on how specific aspects of each jurisdiction's rules - or the interactions between them - are causing particular friction to cross-border flows of capital. This is a source of information that should be exploited more systematically.

6. The inclusion of financial services, both as it relates to market access and regulatory co-operation, in trade agreements entered into by the European Union has the potential to bring real benefits. A successful conclusion to the Transatlantic Trade and Investment Partnership (TTIP) negotiations has the potential to reduce regulatory barriers and enhance market access in the financial services sectors, reduce global systemic risk and increase regulatory co-operation. Given the global dimension to Capital Markets Union, it is essential that trade policy also reflects this new agenda.

Q24. In your view, are there areas where the single rulebook remains insufficiently developed?

1. The previous European Commission has addressed most sectorial issues over the previous legislature. As such, there are no significant areas where new Level 1 legislation is needed.
2. However, whilst the development of a single rulebook in many sectors of the financial services space over the last few years should have led to a more harmonised regulatory framework for alternative investment funds across the EU, differences in implementation of current EU-wide legislation have often resulted in disjointed regimes.
3. By way of example, AIFMD implementation has been inconsistent, with some Member States still to transpose the Directive in national law. In addition (and see the response to Question 11) implementation of AIFMD has not been consistent across the EU. As a result, market participants operating on a cross-border basis must often comply with both EU-wide and additional local requirements.
4. The single rulebook must though be sensitive enough to recognise differences between market sectors (and sometimes even within market sectors). A 'one-size fits all approach' which applies the highest common denominator to all financial markets participants irrespective of their activities, the nature of their clients or the risks they pose to the economy or consumers, is not appropriate. A single rulebook does not mean identical standards for all market participants. It should encapsulate a genuine concept of proportionality and a reflection of the different systemic risk profiles of different parts of the market. The European Banking Authority's recent consultation paper identifying shadow banking entities for the purposes of CRD/CRR implementation provides an ideal case study for this, identifying *all* alternative investment funds as shadow banks, regardless of their characteristics.
5. European Supervisory Authorities (ESAs) have an important role to play in that regard, in particular through Q&As and guidelines. However, no single rulebook can be set up without clear processes to consult the industry at a time where the EBA, ESMA or EIOPA are drafting their recommendations to national supervisors. While ESA Q&As and

Guidelines are non-binding, they have the potential to significantly change the practical effect of EU law and to impact on market participants. Stakeholders must be consulted both on those outputs that are formally binding and on those that will in effect become law because of the extent of national supervisory adherence.

Q25. Do you think that the powers of the ESAs to ensure consistent supervision are sufficient? What additional measures relating to EU level supervision would materially contribute to developing a capital markets union?

1. The overall powers of the ESAs are sufficient, and it is appropriate that they continue to focus on the core tasks: promoting consistent application of EU law with appropriately tailored Level 2 measures and Level 3 action. A single supervisor for capital markets in the EU is not necessary to achieve a Capital Markets Union.
2. There are nonetheless improvements to the functioning of the ESAs that could usefully be made.

ESA Participation at Level 1

3. Coherence and consistency between Level 1 and Level 2 is essential but not always delivered in practice. The ESAs could usefully be involved as non-participating observers in the Level 1 legislative process. By witnessing the legislative process first hand their subsequent work at Level 2 would be better informed by an understanding of the co-legislators' intentions. While the Treaty understandably poses clear limits with respect to the ESAs role in the regulatory process mechanisms could be found to improve this connection while retaining the legitimate distinction between the Level 1 and Level 2 processes and preserving the position and independence of the co-legislators.

Responsibilities of the Parliament and Council

4. Ensuring that Level 2 outputs are consistent with Level 1 must also be a responsibility of the European Parliament and the Council, both of whom should spend more time on engaging in a dialogue with the ESAs over the latter's work. The process of translating and interpreting the intention behind Level 1 texts is difficult and this stage in the policymaking chain could be improved if those involved directly in the Level 1 negotiation were to retain a link during subsequent stages in the process. This does not imply a transfer of responsibility for implementing measures and delegated acts back to the Parliament and Council, but rather a recognition that Levels 1 and 2 are connected and that political trade-offs made at Level 1 will often need to be respected at Level 2.

Involving Stakeholders

5. Delivering coherence and consistency would also be helped by ensuring that stakeholders are appropriately involved. Improvements could be made to both the

Commission's and the ESAs processes to ensure greater transparency and that stakeholders have adequate opportunity to comment on Level 2 measures. More work is needed in particular to ensure that Guidelines and Q&A that the ESAs produce involve stakeholders. Even if they are not legally binding these instruments are of great significance in determining the practical impact and application of EU law. That these can still be produced without any requirement to consult stakeholders denies the ESAs a valuable source of input, damages the credibility of the process in the eyes of market participants, and generates needless uncertainty. But even more importantly decision-makers deny themselves the opportunity to hear stakeholders' views on sources of inconsistency in the application of Community law. Significant progress towards a Capital Markets Union can be built within the framework of existing EU law through the appropriate use of Level 2 and Level 3 powers.

Resources and Priorities

6. ESAs need appropriate levels and types of resource and expertise to be able to function properly and to cope with the increasing number of their duties; draft significant number of technical standards within foreseen timeframe, provide technical input to the Commission, monitor and ensure both consistency in implementation and enforcement across the EU. But equally there needs to be a clear sense of prioritization behind the work of the ESAs, so that there is a focus firstly on those outputs that are legal requirements and then on workstreams that are consistent with the objectives of CMU.
7. A new mindset is needed with those involved in decision-making at all levels accepting that the promotion of the flow of capital across EU borders and internationally is in itself an important policy objective and not merely a secondary consideration.

Q28. What are the main obstacles to integrated capital markets arising from company law, including corporate governance? Are there targeted measures which could contribute to overcoming them?

1. Strong corporate governance rules are crucial to ensure investor confidence and to prevent malpractice. Professionalised and improved corporate governance policies and practices are often one of the benefits that a fund manager can bring to a portfolio company.
2. Corporate governance needs a firm legal underpinning, but one that is flexible enough to recognize differences between companies and their owners.
3. The Shareholders' Rights Directive provides a good example of how proposed company law requirements can also duplicate existing rules for fund managers. For example, a privately-held company that has been backed by a venture capital firm may reach a stage of growth and development at which it makes sense to raise further capital for future investment via an Initial Public Offering (IPO). As a sign of its commitment to, and confidence in, the company that it has already backed for many years (on average around 5 years) the venture capital fund manager usually commits to retaining some



shares once the company has listed. Even though the clear, primary purpose of the venture capital fund is not to hold shares in listed companies but to invest in and develop private companies over the long term it could find that it has now become an “asset manager” under the SRD and therefore caught by its provisions.

4. Under the Commission proposal currently examined by the Council and the Parliament, asset managers would then be forced to disclose overlapping but distinct information to the institutional investor.

Q29. What specific aspects of insolvency laws would need to be harmonised in order to support the emergence of a pan-European capital market?

1. A robust approach to business failure and insolvency across Europe will encourage access to finance, enable viable businesses to be rescued, and will improve growth and sustainability in the overall economy. Indeed it is recognised that having a predictable and transparent insolvency and restructuring regime is essential to investors when assessing the credit risks at the outset of any transaction.
2. In relation to whether specific aspects of insolvency laws would need to be harmonised in order to support the emergence of a pan-European capital market, the private equity industry’s responses to the last European Commission consultation on a new European approach to business failure and insolvency (dated October 2013) remains relevant.
3. In addition, it is probably worth noting that since the financial crisis, we have already seen a divergence in the types of finance available in Europe; in particular, recent statistics suggest that bond market debt already significantly outweighs the amount of credit provided by the traditional loan market. There has arguably already been a significant shift in the availability of public debt, without the lack of harmonisation of insolvency laws causing any major problems.
4. The EU proposals for harmonisation, as set out in the Recommendations in March 2014, were less ambitious than the original 2013 consultation, and were limited to harmonising two key aspects of insolvency law. Namely by inviting all EU Member States to introduce legislation which provides for the early restructuring of debts in order to avoid formal insolvency proceedings, including a stay on enforcement actions, with detailed provisions on the features of a restructuring plan and its confirmation. In addition, the recommendations encourage the promotion of a ‘second chance’ for entrepreneurs in respect of which the Commission recommends a maximum period of three years before discharge from bankruptcy. These objectives seek to achieve the introduction of minimum standards by protecting the value of the insolvent estates, reducing costs, increasing predictability for creditors and shareholders, reducing forum shopping and protecting employment. Whilst we are in agreement with these laudable objectives, we are not persuaded that harmonisation is necessarily something that will deliver these improvements.

5. It is also worth noting that the lack of established restructuring and insolvency regimes in many European countries, which was especially apparent in the context of the recent financial crisis, has however gradually improved with many Member States having recently introduced legislation at a national level in respect of pre-insolvency processes designed to encourage restructuring and rescue (for example, France has introduced accelerated and financial safeguard proceedings, Italy has pre-insolvency and restructuring agreements and Spain has out of court refinancing agreements). In this respect, there has already been a natural convergence in the promotion of pre-insolvency and rescue procedures across Europe, and this, in conjunction with proposals to extend the scope of the European Regulation on Insolvency Proceedings to pre-insolvency and rescue type procedures also referred to in the Green Paper, may be more feasible than a fully harmonised approach.
6. Further harmonisation will require the development of common standards applicable in all Member States, which may be difficult to achieve given the fact that many insolvency laws are inextricably linked to cultural and other differences in areas of national legislation such as property, tax, and company law.

Q30. What barriers are there around taxation that should be looked at as a matter of priority to contribute to more integrated capital markets within the EU and a more robust funding structure at company level and through which instruments?

1. Developments in taxation do not exist in isolation and will necessarily impact on the broader investment environment. Any new rules must be sufficiently precise to address their intended target recipient and must avoid having unintended consequences for the Capital Markets Union.
2. In its Annual Tax Report from 2015 the European Parliament stressed that “*cross-border investments, and in particular private investments, are imperative for the EU economy*” and highlighted that “*‘business friendly’ and ‘investment friendly’ tax initiatives are imperative in order to deliver a sustainable tax system which contributes to growth*”²⁴
3. If fund structures are unfairly penalized such cross-border investments will be impeded. Institutional investors must not be left in a disadvantageous tax position from investing in a fund when compared to investing directly in assets. This tax disadvantage for investors could come from any of several sources such as national withholding tax, application of a potential EU FTT, or disallowance of tax treaty benefits via proposals from the OECD, for example, all of which are all listed below.

OECD Global Work on Tax

4. The OECD’s work on Base Erosion and Profit Shifting (BEPS) project aims to align taxation of profits with the activity that generates those profits, which is a legitimate

²⁴ European Parliament, Annual Tax Report, March 2015 Eva Kaili Rapporteur

objective. However, the current direction of some of the BEPS Actions risks significant negative consequences for Capital Markets Union.

5. Private equity funds, irrespective of their form or investment strategy, typically raise and invest funds internationally and it is imperative that the location and the structure chosen for the fund are tax neutral for the investor. The co-investment or pooling of capital via a fund entity should not itself trigger *additional* tax obligations for investors when compared with direct investment in those same companies or assets. This need to avoid distorting investor behaviour is a sound principle of tax policy, but particularly relevant to the goals of Capital Markets Union. Given the key role that funds play as an intermediary, connecting global investors to small European companies, it is essential that fund investing is not prejudiced by new rules arising from the BEPS project.
6. Of particular concern for the creation of a truly single market for capital in the EU is BEPS Action 6 - Preventing Treaty Abuse in Inappropriate Circumstances. If implemented as currently worded in the OECD discussion drafts, the effect of Action 6 will be to disallow tax treaty access to many alternative fund structures (and to the holding company structures that are used to organise investments and different types of co-ownership). This includes those funds used in the private equity industry.
7. Many funds that invest cross border will simply not pass the proposed Limitation on Benefits (LoB) test. The LoB provision is unworkable for the private equity industry for the following reasons:
 - a. As currently drafted, an intermediary holding company will no longer be able to access any double treaty benefits unless it is listed on a recognised stock exchange or has a major trade or business in the intermediary holding company's jurisdiction;
 - b. The making and managing of investments is specifically excluded from being classified as a trade;
 - c. It also includes a narrowly drafted "derivative benefits" provision which would disqualify a fund entity (including holding companies of a fund entity) as a "qualified person", and would therefore deny tax treaty protection to the fund. This is because at least 50% of the beneficial interests in a fund are often not owned by persons that are resident in the country where the investment vehicle is resident. This is inherent to the nature of international investment funds that raise capital from investors in many different jurisdictions.
 - d. SMEs that receive private equity investment may also be unable to claim the benefits of tax treaties, causing double taxation²⁵.

²⁵ Example: A successful SME decides to license patents to unrelated parties world-wide, receiving royalties in return. The SME wants to claim tax treaty relief for withholding tax on the royalty payments. As long as it is owned by the founders and other local investors in its home country, it would qualify for treaty benefits under Article X(2)(e) of the proposed LOB provision. But if the SME seeks to fund its expansion by taking investment from a private equity fund it cannot rely on article X(2)(e) anymore. It can now only claim treaty benefits if it passes the "substantial business test" of Article X(3) of the proposed LoB. But given uncertainties around the application of the 'substantial business test' this may not be achieved making the investment by the fund unattractive. Only if the private equity fund had a substantial number of *domestic* investors would the Treaty benefits definitely be available. But with private equity funds actively looking to raise capital globally this is not a realistic prospect.

8. Private equity funds have a diverse range of investors who are not disadvantaged in any way when investing in funds rather than directly in the underlying assets. Without an intermediate holding company, such investors could be subject to double taxation. Although a number of investors can either off-set taxes paid against taxes payable in their home jurisdiction or are entitled to relief in their own right by making a claim through a double tax treaty, administratively it is far more efficient that they receive the correct return in the first place without having to resort to treaty claims. The latter would add a disproportionate administrative burden on investors by requiring them to do something which they do not ordinarily do when investing in a fund, or it would force the fund manager to carry out a task for which they are not equipped. But a large number of traditional private equity investors like pension funds are in addition not taxed in the country of domicile on income or capital gains as taxation only takes place when pensions are paid out and received in the hands of the pensioners. For these institutions any or similar levied becomes a direct cost reducing their return.
9. Disallowing funds from treaty access may easily result in double (or even triple) taxation, thereby increasing the tax burden for investors, reducing overall returns and discouraging investment. An investor may become subject to a *higher* level of taxation by investing through a fund than if they had done so directly. This risks reducing the overall attractiveness of investing in private equity and other asset classes in the investment funds industry, making it less likely those funds will be able to play their role channeling capital from global investors to the businesses that need it.
10. As a solution, all fund types (both mainstream and alternative, or Collective Investment Vehicles (CIVs) and non-CIVs as per the OECD definition) should be explicitly excluded from the draft OECD rule on Treaty Abuse, and provision made in the proposed amendments to make clear that the LoB provision and/or main purpose test will not act to restrict the ability of a CIV and non-CIV fund (or associated investment structure) from accessing treaty benefits.
11. If the final deliverable on Action 6 of the BEPS project contains the same policy conclusions as those in the recent discussion drafts, then implementing those ideals in the EU would be wholly incompatible with the objectives of the Capital Markets Union. Such rules would hamper the raising of capital across the EU and discriminate against investment funds as a channel of capital to the real economy. The goal of the Capital Markets Union project is to break down internal barriers when it comes to cross-border investment and allowing double taxation to distort the raising of this capital for investment would completely undermine the project, in our view.
12. If private equity and venture capital are to be promoted as an asset class, then international tax norms that have the opposite effect must not be allowed to develop.

Financial Transaction Tax (FTT)

13. The proposal for an FTT would not be supportive of the aims of a Capital Markets Union. The FTT (in the form proposed) is very likely to be a potential barrier to the deepening of financial markets, including equity markets.



14. In taxing private equity funds, instruments which provide financing for European SMEs, the FTT will effectively be a tax on investors. The FTT will not contribute to Europe's urgent challenges of achieving economic growth and higher employment, but will hamper long-term investment by making such investment more costly (and consequently potentially less attractive to institutional investors). Looking at the structure of a typical private equity fund, the whole sequence of raising capital from investors, investing that capital via long-term, closed-ended funds into companies, often via holding structures, and then providing returns to investors, is one inter-connected investment chain.
15. While the initial issuance of shares/units in a private equity fund will likely be exempt from the FTT via the primary market exemption, virtually every other step in the investment chain will be taxable (yet the nature of these structures means that this must surely go against the spirit of what FTT is intended to address). The primary market exemption for issuance of units/shares in collective investment undertakings will not be sufficient to avoid increasing the cost of raising capital for private equity funds as the whole sequence of raising capital, investing it and providing returns is one inter-connected investment chain. The FTT would therefore result in an inconsistent treatment of instruments across the EU, with long-established and productive instruments being subject to the tax multiple times simply because of their structure.
16. As a result of this, analysis carried out for the industry²⁶ found that the effective tax rate on private equity funds will be much higher than the nominal rate contained in the Commission proposal due to the cumulative impact of the FTT. This research indicates that the effective rate is likely to be 0.6% - 0.8% for a simple private equity fund, which could rise to 1.4% for funds investing on a cross-border basis. The FTT, although aimed in principle at nefarious trading, will therefore also capture sources of European growth, which were not a cause of the economic crisis²⁷ and do not cause systemic risk and which is not trading activity.²⁸

Promoting equity financing via tax incentives

17. The issue of the debt-equity bias has been discussed by European policymakers for some time now. Generally speaking, debt financing is cheaper for companies as well as shareholders due to the differences in tax treatment between debt (where interest is fully or largely tax deductible) and equity (where dividends are paid out of taxed profits and then taxed again as capital in the hands of the shareholders). We firmly believe that the way to address the debt/equity bias is to promote equity financing by offering tax incentives to equity investment, and certainly not by limiting the tax deductibility of interest on debt.

²⁶ ADM Risk, Regulation and Strategy, *A report for the EVCA on the implications of a Financial Transaction Tax (FTT) for private equity*, January 2014

²⁷ Report of the High-Level Group on Financial Supervision in the EU chaired by Jacques De Larosière, February 2009

²⁸ Private equity funds are, by their nature, "not likely to cause systemic risk" according to the Commission Proposal for a Directive on Alternative Investment Fund Managers, April 2009, p. 6



18. Limiting interest deductibility on legitimate business debt would be disastrous for the European business sector. Debt is an essential tool used by businesses, small and large alike, to grow and finance operations. According to the OECD, small and medium-sized enterprises and entrepreneurs across OECD countries continue to face greater vulnerability to credit market conditions due to their heavy reliance on bank credit.²⁹
19. Debt is a fundamental part of a typical company's capital structure and is often used to finance day-to-day operations and essential business activities such as meeting payroll, buying raw materials, making capital expenditures, building new facilities, and financing asset acquisitions. All these financed expenditures are incurred in the ordinary course of a trade or business, and the interest on these loans is therefore tax-deductible. In most countries, the tax law is symmetric with respect to debt. Generally, each euro of interest deducted from the borrower's income is a euro included in the creditor's taxable income.
20. Some private equity funds, such as buyout funds, purchase companies using equity (from the fund and, where necessary, third-party co-investors) and debt (usually from banks, other institutional lenders and often from the fund itself). The funds themselves almost never guarantee that debt. In a large buyout transaction, a buyout fund may, for example, incorporate an acquisition vehicle and make an equity investment; the acquisition vehicle then uses the capital from the fund along with cash from borrowings to purchase the target company, with repayment of at least a portion of the debt being secured by a lien on the assets of the target company and a pledge by the fund or a holding company of the shares of the target company.
21. Debt and equity should not be seen as mutually exclusive or adversarial therefore, rather they are complimentary to each other, especially in the European context where there is a heavier reliance on bank financing compared to the USA. A proposal along the lines of an Allowance for Corporate Equity (ACE) System, as has been introduced in Belgium and Italy most notably, could be an interesting option. The ACE System is a source-based corporate tax system that addresses the debt bias by combining the deductibility of actual interest costs with a deduction of a notional return to equity. It therefore reduces tax discrimination between debt and equity financing by allowing companies to deduct a (notional) interest charge on their equity, in the same way that interest on loans is tax deductible. While the Belgian and Italian experiences have both advantages and disadvantages, the concept of introducing an ACE System on an EU-wide basis would be a very effective method of addressing the debt/equity bias while avoiding tax arbitrage between Member States.

Proposal for a pan-European tax neutral fund vehicle

22. Investors can face discriminatory and prejudicial treatment as soon as they are 'pooled' in a fund and denied the same treatment as those that invest directly into the underlying portfolio companies. A pan-European tax neutral fund vehicle would help to ensure greater transparency and predictability.
23. In many circumstances, investors are faced with the risks of double taxation or unexpected taxes due to the use of a fund structure in a cross-border scenario. This makes investment in private companies less attractive than investing in listed

²⁹ "Financing SMEs and Entrepreneurs 2014: An OECD Scoreboard"

companies or even investing directly in private companies. The fiscal environment can therefore either reduce or reinforce the natural risk aversion of private investors. Put simply, it is necessary to prevent double taxation: first, at the fund level, when it receives income or realises an investment; and second, when an investor receives income or capital from the fund. Tax transparency ensures investors are only subject to tax in their home jurisdictions, just as they would be when investing directly in company shares.

24. A concrete example helps to illustrate this issue. If a Belgian individual decides to invest directly in a portfolio company and realizes a capital gain at the occasion of the exit, he/she will generally not be taxed on the capital gain, irrespective of whether the capital gain is realized with the sale of a Belgian portfolio company or a non-Belgian portfolio company. If, however, he/she decides to invest the same amount into a fund entity, and the fund realizes the capital gain (assuming tax free), the distribution of the proceeds by the fund to the Belgian investor will in most cases be considered as the distribution of a dividend which will be taxable at a rate of 15% or even 25%. If, however, the fund was deemed to be tax transparent for Belgian tax purposes, the Belgian investor would be deemed to earn (his/her pro rata portion of the) capital gains, as a consequence of which he/she would be taxed as if he had invested directly. Similarly, certain Member States, where investments are made, may charge tax on capital gains made by non-residents.
25. As a solution to this, a tax neutral fund vehicle would allow the Belgian investor to overrule the Belgian entity classification rules by enabling him/her to elect the fund to be tax transparent for Belgian tax purposes. This may be achieved, for instance, by enabling the Belgian investor to participate in a pan-European fund vehicle that is mandatorily tax transparent for tax purposes within the European Union. Such rules must also provide for neutrality to any associated structure connected with the fund, such as a holding company or special purpose vehicle.
26. The best and most effective solution to resolve the problems and obstacles referred to above, at least within the EU, would be to create the possibility to use a fund vehicle (i) which is to be treated as fiscally transparent in all Member States irrespective of whether the Member State is the home country of the investor, the fund entity, or the investee company (the “Transparency Rule”), and (ii) that is not considered to be engaged in business for tax purposes (the “Non-Business Rule”).
27. This may be achieved either by way of introducing a European fund entity or by way of introducing a Regulation that requires Member States to observe the Transparency Rule and the Non-Business Rule if the fund and its investors elect the application of this Regulation. The ultimate objective, just like our views on OECD work above, should be that the collective investment through a fund into companies should at least - from a tax point of view - be treated as fiscally neutral when compared to a direct investment by the respective investors. Ideally, this proposal should be implemented globally as this would completely eradicate the anomalies produced from the interaction between different countries’ systems.

Submission

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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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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.

