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LONG TERM INVESTORS

13 January 2019

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

Response to Joint ESAs Consultation Paper concerning amendments to the PRIIPs KID

Key comments

1. Amendments arising from the end of exemption of Article 32 of the PRIIPS Regulation

We are concerned with the ESAs' suggestion to extend some of the requirements of the UCITS Regulation to retail AIFs. We detail in our response the issues such extension would pose given the fundamental differences between UCITS and AIFs structures, especially when the latter are closed-ended.

2. Disclosure of private equity fund's specific costs

We support some of the approaches suggested by the ESAs in their Consultation paper, in particular when a clear distinction is made in the breakdown of costs between carried interest and performance fees. We also ask ESAs to remain mindful of the diversity of fund structures, including closed-ended funds with no redemption rights, when choosing a cost table option.

3. Past performance

We express our concerns with the use on past performance scenarios in a private equity context, as we believe the use of such scenarios could lead to misleading results in light of the specificities of our industry.

4. Exemption of offers made to sophisticated investors

We reiterate our view that sophisticated investors as defined in the EuVECA Regulation should not be included within the scope of the Regulation. We believe it would be essential to clarify that the KID only applies to mass-marketed products and not to offers made to a limited numbers of individuals.

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I. Introduction

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

Treatment of sophisticated investors

Private equity funds[1] are typically structured as limited partnerships with a contractually limited life. They have in the vast majority of cases a term of ten years with an option to extend, normally by two years. The closed-ended partnership interests that form the private equity fund are not intended to be traded. Commitments made by investors into a private equity fund are entered into with the intention of being held for the life of the fund and so are by nature long-term.

For that very reason, private equity managers primarily market their funds to institutional investors, such as pension funds, sovereign wealth funds, insurance companies, banks and government agencies/development funds, who are both looking for and able to make such long-term commitments. While private equity managers will therefore in most cases be outside the scope of the PRIIPs Regulation, there will however be some instances, in particular for venture capital, where prospective investors in the fund will include high-net worth individuals or other types of "sophisticated" or semi-professionals investors.

Irrespective of whether they would fall or not within the KID scope, none of the investors in these funds will be by any standard an average or a typical retail investor, except in (very) rare circumstances (for example listed venture capital funds). Investors in private equity will have a significant experience of these types of funds often because they work in or are in some way connected to the broader private equity industry and sometimes, in the case of successful entrepreneurs, will commit capital into funds that support ideas and projects, or more generally a sector, in which they are an expert.

Despite this, none of these investors will typically meet the MiFID II definition of a professional client. As a consequence, any private equity fund being made available to them (and only to them) will have to prepare a KID despite having an investor base consisting solely of individuals with a long-term commitment, with large ticket sizes and with a thorough understanding of the consequences of their investment.

As we explained in previous submissions, the reason for this is entirely due to the fact that MiFID elective professional tests are calibrated for MiFID investment services provided in relation to liquid assets such as traded shares. We have made many representations over the years on the inappropriateness of the MiFID professional client definition in the context of private equity funds' offerings. In essence, regardless of their wealth, sophistication or experience, the tests are extremely difficult to satisfy for individuals who invest in long-term private equity funds. Moreover, due to the long-term nature of the industry, the number of deals will always be limited. Even for a very large institutional investor the number of funds invested in over a 12-month period would typically be in single figures.

[1] For the purpose of this response, and unless otherwise stated, any reference to "private equity funds" or "funds" shall be deemed to include both venture capital and private equity funds, the former being considered a sub-set of the private equity asset class.

This is a real concern in the context of the Capital Markets Union, as the immediate result of the introduction of the PRIIPs Regulation has been a limitation of these sophisticated investors' investment opportunities, as fund managers often have chosen not to sell their funds to them any longer due to the burden of producing a KID for only a few investors, despite these investors' experience and sophistication.

Overall, the PRIIPs Regulation had an impact on the ability of venture capital funds – for which sophisticated investors typically represent a more significant share of the fundraising – to channel the capital held by these investors towards the EU innovative economy. This ultimately affected the attractiveness of the EuVECA passport that first acknowledged in EU law the value of these investors and allowed fund managers to market to them at EU level.

In that context, we believe the creation of a semi-professional or sophisticated category of investors, and the exclusion of these investors from the requirements set in the PRIIPs Regulation would go a long way in addressing the issues posed by the current framework from the perspective of our members. Another – perhaps simpler, approach would be to clarify the terms "made available" to exclude certain type of offers made on a confidential basis to a limited number of clients. The validity and relevance of both of these options are detailed in our response to Question 5.

Issues related to the specificities of the private equity asset class

Irrespective of our concerns with the scope of the PRIIPs Regulation, we would like to use the opportunity of this consultation to comment on specific aspects of the KID and to point out again the fundamental differences that exist between typical offerors of packaged products – which are at the core of the PRIIPs and UCITS scope – and certain types of alternative investment funds such as private equity.

We stressed in previous responses why private equity funds, which are typically unlisted and closed-ended funds that invest for an average of 5 years in unlisted private companies, cannot be compared to products that have daily price quotes. We also explained why certain typical private equity features, such as the use of carried interest as a pay-out mechanism, should not be presented in a standardised way, in order to avoid giving these investors inappropriate information.

While we believe that ESAs are now taking into account most of these features, we would like to advise them to be extremely careful when making changes to the existing framework. Of most concern to our members within this exercise is the transfer of UCITS KIID rules to retail AIFs, which, in many circumstances, will have very different characteristics from open-ended mass retail funds. We therefore strongly oppose such transfer.

II. Context of the review

Q3. Do you think that the amendments proposed in the consultation paper should be implemented for existing PRIIPs as soon as possible before the end of 2021, or only at the beginning of 2022?

We do not have any particular views on this point.

Q4. Do you think that a graduated approach should be considered, whereby some of the requirements would be applied in a first step, followed by a second step at the beginning of 2022?

We do not have any particular views on this point.

Q5. Are there material issues that are not addressed in this consultation paper that you think should be part of this review of the PRIIPs Delegated Regulation? If so, please explain the issue and how it should be addressed.

As explained in the introduction, we believe that the scope of the PRIIPs Regulation should be reconsidered as quickly as possible to ensure the KID only has to be offered to individuals who really require it. We would like to stress to the ESAs there are two relatively straightforward ways to mitigate this issue without giving rise to investor protection concerns:

- exempting sophisticated investors, as defined in Article 6, paragraph 1 of the EuVECA Regulation, from the scope of the PRIIPs Regulation

All prospective investors, including semi-professional ones, are provided with considerable amounts of information on the fund and the fund manager and carry out their own due diligence prior to making an investment. In addition, as part of their investment, they are required to acknowledge that they understand the risks involved in making that investment. Given their level of experience, which is closer to professional investors than for "typical" retail investors, we do not consider that there is a substantial increase in investor protection should such investors receive a KID.

- consider that a PRIIP should be viewed as "made available" to retail investors within the EEA only where the PRIIP is widely distributed

Retail investors typically represent a very small proportion of the fund's investor base and these would be distributed under private placement regimes when possible. It is a key feature of private placement regimes both within the EEA and internationally that there should be no general solicitation of investors or general advertising of the product. A private equity firm will therefore typically not make any marketing materials relating to its funds generally available on its website.

The PRIIPs Regulation (Article 5(1) and Article 9) requires the KID to be published on the manufacturer's website. This publication requirement gives the impression that the manufacturer is always soliciting retail investors generally, potentially drawing certain investors to asset classes that are not suitable to them. In a private equity context, the private placement memorandum and other marketing materials will on the contrary be distributed on a <u>confidential basis</u> to a limited number of investors only – typically, specifically identified high net worth individuals within the EEA (such as strategic partners in a particular industry sector).

We believe as a result that the requirement to produce a KID should not apply where a manager distributes a fund on a private placement basis, e.g. where marketing materials are distributed to fewer than 150 retail investors per EEA member state. This would be consistent with the thresholds set in the Prospectus Regulation.

As the PRIIPs regime was clearly designed for mass-marketed retail products, and given the unintended consequences of other interpretations, we think it would be reasonable to interpret the concept of a PRIIP being "made available" to retail investors consistently with either or both of the concepts referred to above, and that <u>this might reasonably be addressed through Q&A without necessarily requiring an amendment to the underlying legislation</u>.

III. <u>Past Performance scenarios</u>

Q26. Would you be in favour of including information on past performance in the KID?

We disagree with the assumption that past performance should necessarily be seen as relevant, even in cases where it is available, and we appreciate that ESAs recognised so far that it is not recommended to include past performance for Category 4 PRIIPs.

In general, we believe that using past performance to project future returns can lead to fundamentally misleading results when the product is not exposed to volatility risk. The more the ability of the fund manager depends on factors that are not related to such performance, the higher the chance past performance would not give the investor a proper estimation of the risk he or she faces.

In a private equity context, past performance would for example not take into consideration the fact that the underlying businesses invested in by the previous funds managed by the same fund manager will be different from the investments that will be invested in by the fund currently being raised: the nature of private equity funds is that companies are invested in by the fund, held for a number of years while the fund manager assists the company management team in taking the business through a particular period of growth or redevelopment, then exits the investment, either through a sale of the business to another private buyer or trade buyer, or it is floated on the stock market. When the next fund is raised, it is typically unlikely that there would be an opportunity, or a reason, to seek to invest in these companies again. In the case in the fast evolving arena of venture investing opportunities to create businesses in sectors often arise because of technological developments that make it possible to invest in areas that even a short time ago would not have existed and where, by definition, no track record exists.

None of these factors will appear in the KID, despite playing an important role in determining the risk features of a manager's new fund compared to the previous one. It is also the case that the very long time between one fund being raised and the next means that other factors impacting the performance of previous funds could have changed during that time (e.g. market environment, stage in the economic cycle, evolution of the fund management team).

Relying too heavily on past performance information also carries the danger of over-emphasizing temporary depressed market conditions previous private equity funds have been exposed to at one stage of their lifetime, as well as being too optimistic during periods of market booms that are no longer indicative of a later exit environment.

Q27. Would your answer to the previous question be different if it were possible to amend Article 6(4) of the PRIIPs Regulation ?

No. As explained above, we believe the problem lies with the use of past performance in itself and not with the way it is presented. While further details could help alleviate part of the problem, this would not solve the fundamental issue that for some PRIIPs, such as private equity ones, the calculation of expected performance from the outset of the fund is not a norm. This is due to the fact that it is impossible to establish all the factors and assumptions at the outset of a fund that could be used to construct a probabilistic outcome given the long term and illiquid nature of the funds and investments.

That said, we believe that for certain type of KIDs, such as private equity ones, there could be the possibility of providing a commentary in this section explaining why the narrative explanations may not apply in this case. Furthermore, it may be worth providing additional elements, such as the fact that the presentation of the performance scenarios makes no differentiation between an investment and a commitment.

Q28. Do you think that it can be more appropriate to show past performance in the form of an average (as shown in the ESA proposal for consumer testing) for certain types of PRIIPs? If so, for exactly which types of PRIIPs?

No. Presenting past performance in the form of an average would not take into account all the issues we raised in answer to Question 26, or the fundamental role the fund manager plays in ensuring the success of a specific fund. In a private equity fund context, and more generally for any closed-ended fund with no redemption right, the only relevant performance data to look at is the ultimate return the investor will get at the end of the fund, and not the average performance of the fund over the course of the life.

Q30. Are you of the opinion that an additional narrative is required to explain the relationship between past performance and future performance scenarios?

As explained in our response to Question 26, we are opposed to the inclusion of past performance for certain type of PRIIPs.

Q31. Do you see merit in further specifying the cases where the UCITS/AIF should be considered as being managed in reference to a benchmark, taking into account the provisions of the ESMA Questions and Answers on the application of the UCITS Directive?

We do not have any views on this point as private equity funds are not managed in reference to a benchmark.

IV. Costs

Q33. Do you agree that a fixed intermediate time period / exit point should be used instead of the current half the recommended holding period to better facilitate comparability?

We do not have any specific views on the use of a fixed exit point as opposed to half of the recommended holding period. We would however want to use this opportunity to reiterate our concerns with the obligation to present several recommended holding periods for closed-ended funds where no redemption rights are available.

For closed-ended private-equity funds – and more generally for similar types of illiquid funds - the first two scenarios in the cost table, whatever their length, simply do not reflect the nature of the fund. In these cases, we believe it would be more appropriate for ESAs to give the fund manager the explicit opportunity to only present a holding period that corresponds to the full life of the fund. This would allow the investor to have a more appropriate idea of the length of time it will have to hold the PRIIP and avoid giving her/him the impression that there is an opportunity for him/her to surrender its investments at some point before the end of the fund's stated lifespan.

More generally, we feel that the investor in the fund will be better informed of the illiquidity of the product through a clear disclaimer that there is no opportunity to redeem its commitment before the end of the life of the fund. Such disclaimer will have a higher informative value for the investor than two columns describing high cost of leaving it after a given number of years.

Q37. Are there PRIIPs for which both performance fees and carried interests are applied?

We appreciate the recognition by the ESAs of the difference between performance fees and carried interest.

We are not aware of any private equity fund where both carried interest and performance fees are applied. Nonetheless, we believe it may be easier, given the importance of making a clear differentiation between a performance fee and a carried interest, to treat these in separate rows of the KID. Provided each of these rows would only have to be added to the table when such types of "incidental costs" are effectively applied, this would not extend the length of the KID. At the same time, it would continue to provide for a clear differentiation between carried interest and performance fees.

As a reminder, carried interest is a profit share mechanism typical to private equity, which aligns the interests of fund managers with those of investors. While carried interest is linked directly to the performance of the fund, there are several elements of the carried interest arrangement and its calculation, which makes it different from traditional performance fees, including:

- Carried interest is typically not paid each year: while carried interest arrangements are agreed at the outset of the fund, cash will typically only be paid by the fund to the carried interest participants once investors have had their drawn capital back plus an agreed preferred return (as explained below).

- Carried interest is usually only paid once the fund has achieved the "preferred rate of return": at the outset of the fund, fund managers and investors agree the detailed terms of the carried interest arrangement. This will include a level of return (the preferred return) that will accrue exclusively to external investors, and the pre-determined formula for how returns will be shared between the fund manager and these external investors, once this threshold has been achieved. This means that any investors into the fund will see both the payment of their original investment and an agreed return before any carried interest is paid to the fund manager. For the same reason, there is therefore no guarantee that carried interest will ever be paid: if the fund does not achieve this pre-determined level of return there will be no carried interest. For the avoidance of doubt, this means that, unlike funds in other asset classes that operate on a "high water" basis to trigger their carry, typical private equity fund carry structures only see carry generated if over the life of the fund investors get all their money back and achieve at least the level of preferred return agreed from the outset.

Q38. Do you agree with this analysis from the ESAs? If yes, what are your views on the extent to which fees related to the management of the underlying real estate assets, i.e. the properties themselves, should be taken into account in the calculation of the cost indicators?

First, we would like to clarify that real estate funds and private equity funds have different characteristics and that we are only responding to this question from the perspective of the latter type of fund. We find the ESAs' analysis slightly unclear, as it appears intended to address both fund types, but mostly refers to real estate funds.

We appreciate why the ESAs want to make sure that fees that are exclusively related to the management of underlying assets should be included in the KID. However, in the private equity context it is unlikely that including these figures in the costs section of the KID would be useful to investors.

Fees relating to underlying private equity fund assets generally fall into one of two categories:

1. Asset-related fees that are included in the fund's overall management fee. Because these are typically offset against the fund's management fee, they would not normally constitute an additional

cost to investors. It would therefore be potentially misleading to include them in the KID costs disclosures, and there would be a significant risk of double counting.

2. Fees for additional services, charged directly to the relevant portfolio company. The relevant services are often provided by an affiliate of the fund manager, and priced on an arm's length basis. They relate to the ongoing performance of the relevant portfolio company held by the private equity fund (similar to some types of property-related fees charged in the real estate fund context).

   Our view is that the fees charged for such services should be disclosed to investors in general terms if there is a potential conflict of interest for the fund manager. However, they are not investment-related costs to be borne by investors, and so including them in the KID would again be potentially misleading. Because of their ongoing nature, it would also be difficult (if not impossible) to determine the appropriate amount of such fees that should be disclosed to investors up-front in the KID.

Finally, we would also note that it is difficult for private equity funds to find appropriate peer products to be used as a comparison for their cost calculations, as each fund tends to have very bespoke features.

Q39. Do you agree with the ESAs' preferred option 3 to revise the cost tables?

We do not fundamentally disagree with the approach taken in option 3 but it is not our preferred option.

Q40. If not, which option do you prefer, and why?

Out of the four options proposed, the second one is potentially most appropriate. This is however only due to the fact that this option, to the contrary of Option 3, allows for a single detailed description of costs (as opposed to a description for each of the proposed holding periods). As we indicated in our response to Question 33, we are generally wary, in a closed-ended illiquid fund context, of any presentation that assess the cost at a time where the investor would in any case not be likely, or even not at all be in a position, to walk away from its investment.

Overall, we favour any approach which allows the fund manager to give a clear indication to the investor about the impact of carried interest on its return. As explained in our response to Question 41, we therefore very much support the idea, presented in Option 1, 2 and 3, to present carried interest in a more detailed manner than previously.

At the same time, we would like to use this opportunity to warn the ESAs that, irrespective of the value of presenting costs in a simplified manner in a summary table, this may in some cases give misleading information to the investor, for the very reasons described above. We would therefore call the ESAs to keep a pragmatic approach, in light of the diversity of products that will fall under the KID scope.

Q41. Do you have other comments on the proposed changes to the cost tables?

We very much support the ESAs' suggestion to allow the fund manager to describe, in a maximum of 100 characters, the impact of carried interest as a defined percentage. As can be seen from our description of carried interest in our response to Question 37, this information will be of much higher value to the investor than a single number. Indeed, such a number will necessarily be misleading as carried interest is not *per se* a cost but a percentage of the net profits of the fund, provided investors have received back what they invested in the fund and the fund achieves a pre-defined rate of return.

For example, Option 4 would lead to an outcome where the reduction in return will be set as zero in a default scenario – and this despite the fact there is a definite chance, if the fund is successful, that the investor will share a portion of its return with the manager.

V. End of UCITS exemption

Q46. Do you agree that these requirements from Article 4 should be extended to all types of PRIIPs, or would you consider that it should be restricted to Management Company of UCITS or AIFs?

We do not have any specific issues on the three proposed paragraphs but we would like to remind ESAs that, while all UCITS have to comply with the relevant Regulation, not all AIFs are subject to prudential supervision by a national competent authority. There is therefore a risk of creating an unlevel playing field for many AIFs that are not regulated by any financial authority. This is particularly true for paragraph 12 of Article 4.

Q47. Do you agree that this requirement should be extended to all types of PRIIPs, or would you consider that it should be restricted to Management Company of UCITS or AIF?

We are opposed to the extension, without a careful analysis of the relevance of the transposition, of the requirements set in the UCITS Q&A, not only to all type of PRIIPs, but also (and in some cases especially) to management companies of AIFs.

Given the difference in nature between AIFs and UCITS, we find that it would be preferable for UCITS to be classified as a separate category, to avoid impacting the treatment of AIFs which will not always subject to the same rules and which, when closed-ended, will have very different characteristics from UCITS funds.

A good example of this is Q&A 7, which refers to the publication of an up-to-date remuneration policy, which is a requirement exclusive to the UCITS which are required to mention this information in their UCITS KIID as per the UCITS legislation.

Q48. Do you agree that these requirements should be extended to all types of PRIIPs, or would you consider that they should be restricted to the Management Company of the UCITS or AIF?

As we explained in our responses to the questions above, the amount of Articles that will have to be transposed from the UCITS KIID to the PRIIP KID demonstrates the complexity of such a shift.

Any rules transposition would require careful consideration to ensure the nature of all PRIIPs but also all AIFs – which sometimes have very different structures than UCITS – is respected. The question of the extension of UCITS requirements to retail AIFs is therefore one that can be as complex as the extension to other PRIIPs. Taking this into consideration, we disagree with the ESAs that it is granted that the KIID framework should start applying to retail AIFs.

From the perspective of our industry, there is a clear danger in transposing rules that were thought and produced in the context of open-ended structures mass-marketed to retail clients, to closed-ended AIFs solely offered, most often under a confidential basis, to sophisticated individuals. In the same way UCITS rules differ from AIFMD ones, and in the same way the AIFMD has different set of rules for different types of AIFs, rules related to the marketing information should differ from UCITS funds and retail AIFs.

We would like to again point out that an obvious solution to part of the issue potentially created by this extension would be to restrict the scope of the KID to products that are widely distributed to retail investors. This would ensure that closed-ended AIFs which are most different from UCITS do not comply with rules that, from our perspective, are not appropriate to them.

More specifically, here is a non-exhaustive list of potential issues with the application of Articles 7, 9 and 15 to 21 of the UCITS Regulation to AIFs and their managers:

Regarding Article 7, and as pointed out by ESAs in their consultation paper, it should indeed be clarified that there is no possibility of redemption for certain retail AIFs such as private equity funds.

Regarding Article 15 to 20, we strongly oppose the use of past performance in a private equity context for reasons that are detailed in our answer to Question 26 of this consultation. Moreover, applying past performance calculated on the basis of the NAV may pose problems for private equity funds where the calculation of the performance will differ significantly than for open-ended UCITs.

Regarding Article 20, we are concerned that some of the information contained in this section will not be relevant to all AIFs, and in particular those that are not regulated under the AIFM Directive and/or by any national competent authorities, that do not have to appoint a depositary. Moreover, some of the language (such as the “price of units”) may not be as relevant in a non-UCITS context.

Overall, the sheer number of differences between a UCITS and a closed-ended AIF makes us concerned that several UCITS marketing concepts would start to be applied to those AIFs, irrespective of these differences. In light of this, it may be much simpler to maintain a clear distinction between UCITS and AIFs, or at least closed-ended AIFs.

From a more general perspective, we would urge the ESAs to be extremely cautious about any tentative of harmonisation between the UCITS and the AIFMD framework. This always bears a significant risk of impacting negatively AIFs (or UCITS) with specific business models and operating mechanisms.

Q49. Do you have any comments on the proposed approaches in relation to the analysis and proposals in this Section, and in particular on the extent to which some of the abovementioned requirements should be extended to other types of PRIIPs?

Please see our comments above.

Contact

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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 Invest Europe

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

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

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

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

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

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