INVEST EUROPE

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

Response to ESMA Call for Evidence on the European Commission mandate on certain aspects relating to retail investor protection

1. General questions

Q1: Please insert here any general observations or comments that you would like to make on this call for evidence, including any relevant information on you/your organisation and why the topics covered by this call for evidence are relevant for you/your organisation.

We would like to make several high-level remarks regarding the implications of the retail strategy for the private equity and venture capital industry. Most importantly, we would like with this response to provide ESMA with intelligence on the extent to which the private equity market is and could be opened to retail investors. We hope these comments will help ESMA to take into consideration the features of this asset class in its future retail-related considerations.

Private equity funds[1] are typically closed-end structures set up for an average of 10 years (usually renewable for two additional years). This **long-term and illiquid structure** has implications on the way private equity fund managers provide investment opportunities to investors across Europe and globally. For investors in the asset class, selling their stake of the fund before the end of the fund's life is neither endorsed nor in anyway incentivised, as the capital committed will serve supporting businesses over the entire length of their growth.

This model has a direct consequence: while private equity funds are not "complex" products (managers invest directly in real businesses, as opposed to complex financial products), committing capital directly to a private equity fund requires **careful consideration and a strong liquidity profile** from investors. As a result, private equity has been traditionally reserved to knowledgeable investors able to commit reasonably large sums of capitals while remaining patient. The make-up of a private equity fund investor base will on average be:

- *circa* 70% of **institutional investors**: pension funds, insurers, banks, sovereign wealth funds, fund-of-funds
- *circa* 30% of **sophisticated investors**: family offices, entrepreneurs

Institutional investors will of course be considered as professionals under the MiFID II "investor categorisation" test and are not the target of this call for evidence – but sophisticated investors will

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

often be deemed retail and we would therefore want to address their situation as part of this response.

Sophisticated investors

When these investors are deemed to be retail investors, it is not because of a lack and knowledge of the product they invest in, but because the definition of "professional upon request" under MiFID is not tailored to the types of investments they are making.

In other words, these investors' level of sophistication is not well quantified through the criteria of the existing MIFID "professional upon request" definition. Looking at two of the three existing criteria (the wealth criteria being appropriate from our perspective):

(i) *"the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged. "*

Some types of sophisticated investors will **have an expertise of the underlying investment market,** which derives from their work in or connection to the broader private equity industry or, in the case of successful entrepreneurs, of their expertise of the sector and projects in which the fund invests

(ii) *"the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters"*

Sophisticated investors **invest large sums of capital** after having negotiated their entry in the fund with the manager – <u>as opposed to making frequent but small investments in standardized products</u>

The result of the MiFID investor categorisation as it currently stands is therefore that these "sophisticated investors" will often be classified as retail clients, despite being extremely knowledgeable of the investments they are making. For example, a successful bio-tech entrepreneur who would decide to invest into a bio-tech venture capital fund will never be in a position to be a "professional upon request" because it is neither a day-to-day trader nor has worked in the financial sector, despite its obvious ability to determine the risks, costs and potential performance of its investment.

Naturally, this has consequences on their ability to access the asset class and, ultimately to commit capital into innovative projects through venture capital or private equity funds, if only because:

- fund managers are not authorised to market to them at European level under the relevant passport (in this case, the one granted under the AIFMD)
- managers often decide not to market to them as they would have had to prepare disclosure documents, such as the KID, solely for these clients (this is especially true as typical private equity funds do not at all target other types of retail clients).

Other investors

Investors other than professional and sophisticated clients committing (very) large amount of capitals typically do not have a direct access to the asset class. Indeed, the long-term nature of the asset class, characterised by a lack of redemption rights and generally large tickets, make it difficult for managers to market to retail clients.

This of course does not mean they cannot benefit <u>indirectly</u> from the long-term, generally preferable, returns offered by the asset class. Much can be done in the future to allow more institutional investors such as pension funds or insurers that manage retail money to commit capital into private equity funds. As DC schemes start to develop in Europe, making sure these are not restricted solely to bonds and listed shares would go a long way in ensuring that retail investors, while protected under the relevant law, may enjoy the benefits that a long-term asset class such as ours can offer.

There are also a few situations where private equity managers will market directly to retail clients. First, certain managers have decided to list themselves – allowing their clients to subscribe to shares of the listed private equity company.

Second, some fund managers market to retail clients which are willing to commit relatively large tickets (above €10K but below €100K) over a long period of time. While growing over the past few years, the number of managers interested in this strategy remains relatively low given the high costs that direct marketing to retail represents for a fund manager, especially if investors must be given the opportunity to redeem their shares. Managers interested to seek such retail capital are particularly interested in labels such as the European Long Term Investment Fund (ELTIF) one.

Contrary to the investors mentioned above, we acknowledge that these types of investors should continue to be treated as retail.

In most cases, the private equity firm will call a MiFID distributor to access these clients and will hence be subject by the retail rules that are and will be developed in the EU. It is therefore important that regulators also acknowledge the features of such products when drafting requirements that apply to their selling (for example, by recognising that illiquid products often do not have daily prices).

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.

For more information please visit www.investeurope.eu.