16 December 2021

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 regarding the PRIIPs Regulation

1. Please provide 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.

The European private equity industry appreciates to be consulted on the potential review of the PRIIPS Regulation.

We would like to use this first question to remind ESAs of the specificities of the private equity industry and the implications this can have on the way managers we represent would prepare Key Information Documents – and how valuable these documents would be for their investors.

In general, we insist on two key aspects:

- many of the investors into our asset class are very experienced despite not having the professional label
- the illiquid nature of our asset class makes some of the "standardised" elements of the KID at best irrelevant or at worse confusing for the investor

As a general reminder, our industry covers a wide range of closed-ended fund managers which share the same business model:

- raising capital from investors
- "pooling" into long-term (typically 10 years), illiquid, closed-ended and unleveraged funds
- investing it in direct equity investments into a dozen of businesses for an average of 5 years
- actively supporting the growth of these businesses, thanks to both the capital and the know-how of managers
- once they have grown and/or evolved, selling the shares either through an IPO or a trade sale

Such a model implies a different path to profitability than public ones. At least a few years will be required before the capital committed, and the actions taken by the manager bear fruit. The fact that selling early is essentially not an option for any private equity investor **makes it *de facto* a long-term, illiquid investment**[1]. The consequence is that, while private equity is by no means in itself a complex investment, committing capital to a private equity fund does require careful consideration and a strong liquidity profile from investors.

Sources of capital that flow to the asset class reflect this. Professional and knowledgeable investors being less likely to have to sell their interests in the fund before the end of the fund's life, at least 80% of investments comes from investors that are by definition classified as professional under the

[1] Although a secondary market in fund interests may exist, the terms under which an investor could sell their position on the secondary market to another investor are generally very limited.

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MiFID investor categorisation[2] and around 5% from corporates (which are likely to also be eligible given their typically large size).

As half of the remaining share will come from institutions, such as universities, or family offices or foundations (9%), “true” <u>private individuals only constitute around 7% of the private equity investor base</u>:

These can be divided in 3 sub-categories:

I. Sophisticated investors with (very) large amounts of capital at hand (committing more than €100K in a single investment)

We have long argued, in other contexts, that these investors should never have to receive a KID as they are effectively as experienced and knowledgeable as other professionals.

II. Investors with a good understanding of the market looking to invest capital with no liquidity concerns (investing typically between €5K and €100K in a single investment)

In all likelihood, these investors will access the asset class through intermediary MiFID firms. We do not dispute that these investors will require a KID – and most of our responses will relate to the marketing of products to these clients (typically through national retail regimes or through ELTIF structures).

III. Small, often inexperienced investors, with liquidity concerns and investing typically small amounts (below €5K)

The very long-term nature of the private equity asset class and liquidity concerns of small retail investors undeniably make it difficult for them to access the asset class directly, either because of their own risk profile or because it is too costly for managers to grant them redemption rights.

Private equity KIDs are therefore not typically prepared for this type of clients. These clients will however have exposures to private equity while buying a packaged pension or insurance product – which will itself be subject to the KID.

Comprehension Alert

7. What are your experiences regarding the types of products that include a comprehension alert?

It is our understanding that most private equity products will have a comprehension alert as only plain vanilla retail products will not be subject to this requirement.

Nonetheless, we would argue that a typical private equity product – which is essentially a package of investments into 10-15 real businesses – is not in itself a “complex” product, albeit an illiquid and potentially risky one.

The mention of such an alert is therefore not very helpful for some products and a “long-term alert” (and the risk assessment) would give more valuable information to the inexperienced retail investor. The alert recently introduced in the ELTIF framework would be a good example in that regard. ELTIF

[2] Annex II, Section I, paragraph (2) of MiFID

indeed could in the future require a “clear written alert that the product may not be suitable for retail investors that are unable to sustain such a long-term and illiquid commitment” for investments longer than 10 years.

For experienced investors described in our introduction (sophisticated clients), our experience is that the comprehension alert is in practice often disregarded as something of little relevance and value to determine whether to make an investment or not.

8. Do you have or are you aware of the existence of data on the number and type of products that include a comprehension alert? If you have such data, would you be in a position to share it with the ESAs?

We understand that most products which are not UCITS have to comply with this obligation. As a consequence, the impact of such warning might be diminished and make little sense to investors.

9. What are your experiences regarding the extent to which retail investors take into account the inclusion of the comprehension alert?

We feel that such comprehension alert is not helpful in itself and might be considered as a deterrent.

12. For PRIIP manufacturers or sellers:
(a) Please describe the different types of costs incurred to comply with the PRIIPs Regulation.

The costs relating to compliance, the collection of product data/inputs, the performance of the necessary calculations, the update of IT systems, quality and content checks and outsourcing are the most expensive factors with regards the preparation, maintenance and distribution of KIDs.

The collection of data and the use of IT tools to store it generate important costs. The calculations and their verification are the most time consuming and require the most control. Given the small average size of private equity firms, these activities are often outsourced and bear an important cost, as they have to be prepared separately from other sources of information required by the investors.

15. What are your experiences as a product manufacturer or product distributor or financial advisor regarding the preferred media for retail investors to access or read the KID? Are there challenges for retail investors to receive the KID in their preferred media, such as due to a certain medium not being offered by the distributor?

We do not have any specific data on the preferences of retail investors in this respect but we believe that the way for the KID to be made available should be left up to the manager’s discretion.

18. Should changes be made to the PRIIPs Regulation so that the KID is better adapted to use on different types of media?

In our opinion, similar rules should apply as far as possible to information is disclosed via digital means and to information disclosed otherwise. We do not believe it is necessary to have different formats for paper, digital or other media. Investors should have a single document that they can read on screen or on paper and that has the same format, thus avoiding any confusion on the part of the reader. Most importantly, cybersecurity and protection of access to data (in particular to personal data, as per the GDPR) should be ensured at all times.

Scope of the PRIIPs Regulation

21. Do you think that the scope of the PRIIPs Regulation should be changed with respect to other specific types of products and if so, how?

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. See our more detailed response to Question 26.

25. Do you think that the definitions in the PRIIPs Regulation relating to the scope should take into account other elements or criteria, e.g. relating to the maturity of the product, or relating to a product only having a decumulation objective, or where there is not active enrolment?

We would like to use the opportunity of this question to comment on the treatment of carried interest and co-investment arrangements, which we believe could be carved out more clearly from the scope.

As a way of background, private equity funds commonly have in place arrangements which permit executives to invest alongside the funds they manage – typically also an investor requirement. Given these funds are predominantly designed for institutional and professional investors, these arrangements allow team members at the fund manager to be accorded interests in a limited partnership (the "carry vehicle") which is, in turn, a limited partner in the main fund. Executives will then be entitled to carried interest based payments only if the investors first have received back their contributed capital and any "hurdle return" above a preferred rate agreed at the outset. Co-investment arrangements will operate in a similar manner, allowing the fund manager's staff to participate in a limited partnership which invests alongside the main fund in the underlying private equity investments.

We do not think that carried interest and co-investment arrangements fall within the definition of a PRIIP or within the spirit of the PRIIPs regime since:

- these arrangements are not "packaged" nor they are "manufactured" to provide investment opportunities to retail investors;
- they are solely open to management/ senior executives and employees of the firm respectively;

As the principal purpose of the KID is to ensure that retail investors are adequately notified of the characteristics of a PRIIP to enable them to make informed investment decisions, it indeed makes no sense for executives working in the fund manager to draft such a document for a legal vehicle which has been created for their own investment

- these arrangements form part of the private equity risk sharing model, which aligns the interests of the fund manager and investors and ensures that the investment team has "skin-in-the-game";

- these arrangements are expected, and often required, by investors in the fund

In other words, preparing a KID for these arrangements would essentially mean the manager would prepare a KID for itself, which seems counterintuitive.

The proposal by the European Commission to revise the ELTIF framework constitutes an interesting comparison in that regard, as it clarifies that "suitability assessments should not [be] required where the retail investor is a member of senior staff, portfolio manager, director, officer, agent or employee of the manager or of an affiliate of the manager and has sufficient knowledge about the ELTIF concerned” (Article 30, paragraph 3).

26. Do you think that the concept of products being “made available to retail investors” (Article 5(1) of the PRIIPs Regulation) should be clarified, and if so, how?

Yes. We call the legislators to clarify that a PRIIP should only be considered to be "made available" to retail investors where it is effectively **widely** distributed.

The publication requirement set in Article 5(1) and Article 9 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. This view is reinforced by the fact that this concept is also used in the UCITS Directive – indicating again that the “made available” concept relates to mass distribution.

In a typical private equity context, the private placement memorandum and other marketing materials will on the contrary be distributed on a confidential basis 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). Moreover, a private equity firm will often not make any marketing materials relating to its funds generally available on its website.

It would make sense thereby for the requirement to produce a KID not to 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.

Arguably, this might reasonably be addressed through Q&A without necessarily requiring an amendment to the legislation.

Differentiation between different types of PRIIPs

28. Do you think that the current degree of standardisation of the KID is detrimental to the proper understanding and comparison of certain types of PRIIPs? If so, which products are concerned?

Yes. We comment on this from our perspective as sellers of closed-ended, illiquid products.

Seeking to present the information in a uniformed manner may end up confusing the investor – as it will give him/her the sense that products are inherently comparable and similar – which they may not always be. This is especially problematic within the investment product category – where non-traded products such as private equity or real estate are fundamentally different from others (and sometimes more different than insurance products can be from other investment products).

The primary goal of the KID should remain to offer the investor information on the key characteristics of the product itself (for example, in a private equity context: the lack of redemption rights, the importance of the managers’ skills in driving a return or the impact of carried interest) - allowing her/him to make an investment decision on that product specifically.

On the other hand, the KID should not always seek to compare between financial products with fundamentally different features. From our perspective, many of the “sins” of the KID originate from this overambitious “standardization” objective.

More specifically, in a private equity context the KID should not necessarily:

- force managers to give performance and cost scenarios over different periods despite the product having no redemption rights and periodised scenarios.

Irrespective of any added narrative, this may give the false impression that selling before the end of the fund term's is more of an option than it is.

- present costs of investing into long-term products in the same way as products that have daily price quotes

The presentation of carried interest is a good example of this. As a reminder, carried interest is an agreed percentage, at the fund's onset, of the cash profits of the fund indeed. It is only paid out to the manager and/or to its executives who participate in the carried interest arrangements once the external investors have received back all of their drawn down capital, plus an agreed preferred return (typically 8% p.a. on the investors' drawn down capital).

A "standardized way" to present carried interest, for example as a percentage of the investment if you exit after one year and based on an average performance scenario, will likely lead to a situation where the retail investor will have an impression no amount will be paid, which will not necessarily be true (especially as the investor will not be in a position to exit after a year).

A "simple" way would be for the KID to contain a short sentence describing that the fund is subject to a profit-sharing mechanism above a certain hurdle – which would give the investor all information he or she needs to make the investment.

29. Do you think that greater differentiation based on the approaches highlighted above, is needed within the PRIIPs Regulation? If so, what type of approach would you favour or do you have alternative suggestions?

Yes. As explained above, trying to give investors information in a too simplified and too standardised manner, the KID ended up confusing them about the basic nature of some of the products offered.

For example, for closed-ended private-equity funds – and more generally for similar types of illiquid funds - the first two scenarios in the cost table simply do not reflect the nature of the fund. In the private equity case, we believe it would be more appropriate 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. There may however be side clarifications of what happens in case of exceptional events such as deaths or illnesses that lead to redemptions.

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 or limited 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 the cost of leaving it after a given number of years, which may give investors the impression this is a frequent option.

From a risk and performance angle, the same is true for the use of specific methods of calculation which may be suitable for liquid markets but will not always be relevant in other contexts.

By trying to create a “one-size-fits-all”, the KID may create false expectations – especially on products such as private equity where the ultimate success of the fund will depend less on past performance or market indexes than on the manager’s ability to grow real businesses. We believe this is ultimately creating more risks than benefits for the investors.

Complexity and readability of the KID

31. Would you suggest specific changes to Article 8 of the PRIIPs Regulation in order to improve the comprehensibility or readability of the KID?

In general, private equity managers find that Article 8 is too prescriptive, leading to difficulties in filling out the KID.

As mentioned above, the current rules make it complex for fund managers to make some of the key features of the industry visible, including the non-redeemability of investments and the nature of underlying investments which, contrary to most liquid assets, are not basket of securities but actual stakes in businesses.

Article 8 should be amended to give more flexibility to managers to inform clients about the nature of the products they offer.

- <u>Article 8 paragraph 3 (b) on a comprehension alert</u>

We understand the objective of raising the attention of retail investors on the specificities of such funds. However, **such comprehension alert is not helpful in itself and might be considered as a deterrent**.

Enhancing retail investors’ financial education and/or distributors’ training - so that they can better explain the specificities of the product to potential investors – would be more efficient that such a warning.

Please find further comments on the comprehension alert in section II.

- <u>Article 8 paragraph 3 (c) (iii) on the investment horizon</u>

We believe **it would be more appropriate to give private equity fund managers the opportunity to only present a holding period that corresponds to the full life of the fund**. This would allow investors to have a more appropriate idea of the length of time they will have to hold their fund and avoid giving them the impression that there is an opportunity for them to dispose of their investments at some point before the end of the fund’s stated lifespan.

More generally, **investors in private equity funds will be better informed of the limited liquidity of these products through a clear disclaimer that there is no opportunity to redeem their commitment before the end of the life of the fund**.

In particular, **disclosing performance and cost scenarios over different periods for products with no redemption rights may confuse investors** and give them the false impression that selling before the end of the fund term’s is more of an option than it is.

- <u>Article 8 paragraph 3 (d) (iii) on performance scenarios</u>

In the case of private equity funds, the first two performance scenarios are not helpful because calendar references (one year and five years) are totally disconnected from the products, which are closed-end funds with a life of 10 years. Performance scenarios should therefore be more consistent with the investment horizon of the relevant products.

Please find further comments on past performance scenarios in section VIII.

- Article 8 paragraph 3 (f) on costs:

Investors generally pay attention to information on costs and to the break down the different cost items and their respective weight. However, **some of these elements are not fully relevant to retail investors, and some others might not be adapted to private equity funds**.

- Generally, some elements shown in the KID are not fully relevant to retail investors and the level of detail on fees should be adapted. **Retail investors are mostly interested in the total cost of their investment**, not necessarily in the breakdown of the different cost items.

- Moreover, **some cost disclosure requirements are not adapted to the specificities of VC/PE funds**.

– For instance, **the average annual fee rate** is calculated on the basis of an assumption of fund raising (although there is no commitment on the part of distributors to raise funds). As a result, the percentages displayed may be far from reality if the fundraising is higher than the base scenario. Conversely, if inflows are lower than expected, there is a risk that the management company will ultimately have to bear costs.

– Also, **a clear distinction should be made in the breakdown of costs between carried interest and performance fees**. As explained previously, a clear differentiation should be made between a performance fee and a carried interest; these two items should be treated in separate rows of the KID (see answer to Question 28 for the explanation on carried interest).

Furthermore, the presentation of costs set out in the PRIIPs Regulation may follow a different layout and **concordance tables will be required**.

32. How could the structure, format or presentation of the KID be improved e.g. through the use of visual icons or dashboards?

We are agnostic regarding the structure that is used – provided there is sufficient flexibility for the manager to inform the client about the nature of the product.

As explained in other parts of this response, the information should be less standardised to allow managers offering products with different characteristics to alert clients about these characteristics. Any visual icon or dashboard should be sufficiently adaptable to take this into account.

We would like to take this opportunity to highlight the fact that the KID may not always be a paper document but may be an internet page on a website. This should be taken into account when designing the format of the KID. Conversely, the cost of complying with new requirements should be considered and producers should be allowed some time and discretion to implement any new changes to the format of the KID.

Performance scenarios and past performance

33. Do you agree with the ESAs' assessment in the Final Report (JC 2020 66) regarding the treatment of past performance?

Yes. We support the recent ESAs' clarification that past performance should not be given for closed-ended funds where such performance effectively does not exist.

As a way of background, past performance is a more relevant factor for open-ended funds which continue to operate for many years under similar parameters. In private equity, or for any type of closed-ended funds, past performance would always have to be based on previous funds ran by the management team or comparable funds.

As private equity funds invest into businesses - as opposed to a basket of securities linked, for example, to a volatility index, a fund' success will primarily depend on:

- **extensive due diligence** - to "handpick" the right companies to invest in
- **managerial skills** - as managers often take an active role in the company to ensure its success
- macro-economic and industrial trends, i.e.: the business environment

The first two factors may be relevant for funds previously ran by a same management team (although it will not account for the accumulated experience of the management team) but they will not be for a comparable fund. Contrary to passive funds based on listed indexes, the performance of a fund may vary significantly depending both on the sector of investment and the expertise of the manager. It will closer to a general indication of the returns of the asset class than to a clear signal of what returns are to be expected.

Even for funds ran by the same management teams, past performance data will not take into consideration that underlying businesses invested in by the previous funds managed by the same fund manager will often be very different from the investments that will be invested in by the fund currently being raised. The very long time between one fund being raised and the next means that, even for investments in the same businesses, 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. Compared to listed indexes, these factors that are even harder to summarise in a simple document.

Past performance information therefore 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.

34. Would you suggest changes to the requirement in Article 8(3)(d)(iii) of the PRIIPs Regulation concerning the information on potential future performance, and if so what would you specifically change in the Regulation?

From our perspective as closed-ended funds, we would not suggest specific changes to the Article. It seems of utmost importance to us that future performance scenarios are tailored to the relevant type of funds. As explained previously, closed-ended funds cannot be treated in the same way as open-ended funds.

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.

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