THE VOICE OF
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PRIVATE EQUITY
INFRASTRUCTURE
LONG TERM INVESTORS

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

Position Paper

Review of European Supervisory Authorities

December 2017

Key points

1. **Enhanced governance and accountability** (*Article 16 and 45*)

We welcome amendments to increase the functional independence of the European Supervisory Authorities (ESAs) and to further improve their dialogue with industry stakeholders. We think the creation of an Executive Board will have a positive impact on the ability of the ESAs to oversee financial markets and ensure supervisory convergence.

2. **ESAs Direct funding** (*Article 62*)

While we recognise that the ESAs need appropriate levels of resource to properly perform their functions, we fear that any new funding arrangement based on industry contributions will be significantly more complex under the new approach. This risks treating unequally different parts of the financial services industry. Moreover, in light of the proposed change, the ESAs' current governance and accountability structures should in any case be made more robust in order to guarantee the legitimacy, efficiency and necessary oversight of the Authorities.

3. **Direct supervisory powers** *(EuVECA and ELTIF Regulations)*

While we see some benefits of granting ESMA powers to directly supervise EuVECA and ELTIFs, as it may ensure better harmonisation and supervisory convergence, it could also make the supervisory process more complex and costly. This in turn might limit the attractiveness of these voluntary passports and ultimately undermine the Commission's Capital Markets Union objectives.

4. **Delegation and outsourcing activities** (*Article 31a*)

Delegation and outsourcing arrangements are already subject to strict EU rules and we are not convinced that an additional role for ESMA in the authorisation process is necessary. We are concerned that ESMA's engagement will only further complicate the existing procedures and result in a prolongation of the time required for the authorisation process.

Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20
F +32 2 725 07 04
www.investeurope.eu
info@investeurope.eu
VAT: BE 0424.557.716
IBAN: BE33 3300 5785 0046
BIC/SWIFT: BBRUBEBB
European Transparency
Register: 60975211600-74

Introduction: role and characteristics of the private equity industry

The private equity and venture capital industry, referred to throughout this paper as “private equity”, is an essential component of the funding system for European businesses. Private equity investors connect 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.

Every year private equity managers invest over 50bn EUR into 6,000 companies, a large majority (83% in 2016) of which are SMEs. Over the last decade more than 550 billion EUR has been invested into 40,000 businesses, with approximately 8 million people in Europe working in a private equity backed business. With the support of these managers these businesses are more innovative, productive and resilient than their peers with other types of owner, which contributes to higher growth and job creation.

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, which are the recipients of 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.

While private equity fund managers fall under the general term of “alternative investment firms” and are regulated as such under the AIFMD, they have very different characteristics from other types of AIFs. They typically only market to sophisticated and professional investors, they do not offer redemption rights for investors (and therefore pose little liquidity risks), they predominantly invest in unlisted securities (their investments are not directly affected by market movements) and they do not generally need to deal or take management decisions on a short term or day to day basis. These characteristics affect their risk profile and distinguish them from other asset classes.

Detailed comments

I. Governance *(Article 45 of ESMA Regulation)*

We agree that functional independence of the ESAs is a prerequisite to their success and believe that ensuring this independence, through the creation of an Executive Board, is an important component of the review.

Our experience suggests that when an ESA was faced with an issue that impacted directly on the national competent authorities' interests (such as the issue of host fees and charges under AIFMD and EuVECA) the Authority's ability to act was typically constrained. The creation of an independent Executive Board, could help to simplify the ESAs' decision-making and ensure that their decisions are taken with a pan-European perspective.

This change might have more of an impact on the ESAs' ability to act to ensure supervisory convergence than the extension of their supervisory powers. It could also potentially have efficiency benefits, as less time and effort might now be required for the ESAs to take decisions.

The presence of an Executive Board could also allow the ESAs to more effectively settle disagreements between competent authorities, without forcing Member States to be both judge and jury in these cases. Given national competent authorities will remain closely involved in the functioning of the ESAs (for example, as members of the Supervisory Board) they will continue to benefit from the expertise of national regulators.

II. Enhanced procedures for guidelines and recommendations *(Article 16 of ESMA Regulation)*

We very much welcome the amendments to the procedure under which the ESAs prepare their guidelines and recommendations, such as the requirement to undertake a cost/benefit analysis, the obligation to consult the industry beforehand and the role given to the ESMA stakeholder group.

However, it is important to note that most of the issues faced by the private equity industry over the past few years were first and foremost related to the content of the Q&As produced by ESMA, rather than the content of guidelines and recommendations. Despite the fact that these Q&As are not legally binding, they were often determining factors for national authorities' application of EU law and had a significant impact on how private equity firms have been required to conduct their business.

For example, ESMA published an updated AIFMD Q&A to clarify new questions dealing with the delegation of functions by an AIFM to AIFs or third parties. This change had significant implications for certain fund structures. While the industry felt the Q&A was wrong in law, it was neither able to comment on it in advance nor to benefit from a transition period to adapt its fund structures. Ultimately this change created legal uncertainty which could have been avoided if procedures similar to the ones that will now apply to guidelines and recommendations were in place.

While we support the role of Q&A in increasing supervisory convergence, we would call for these to be subject to the same better regulation principles as guidelines and recommendations. An opportunity for stakeholders to offer input prior to the publication of revised Q&A documents should be guaranteed, whether under the form of a web-based tool or any other option which could offer stakeholders the opportunity to provide feedback – solicited or unsolicited - on issues they may have a specific interest in. We also note that this view was endorsed by the Securities and Markets Stakeholders Group in its End of Term Report on 30 June 2016.

III. Direct funding of the ESAs *(Article 62 and 62a of ESMA Regulation)*

We recognise that ESAs need appropriate levels and types of resource and expertise to be able to properly perform their functions and to cope with the increasing demands they face, such as drafting significant numbers of technical standards, providing technical input to the Commission, or monitoring and ensuring consistency in implementation and enforcement across the EU. However, the new funding model raises various concerns as it will be significantly more complex than the current approach for little or no obvious gain.

The approach introduced under Article 62a poses significant practical questions as it would require the development of appropriate criteria to determine the amount of contribution each sector and/or entity would have to pay. However, the current drafting of this Article does not provide any clarity whether market participants will be subject to different fees based on criteria other than their size. This would inevitably risk creating an unequal treatment between different parts of the financial services industry. Even within the asset management industry, there is a wide variety of players, all with different business models and with different exposures to regulation. For example, the alternative investment fund (AIF) category will be composed of a very diverse range of firms from the largest hedge fund houses to the smallest venture capital managers, all of which bear different risk profiles and are not subject to the same requirements under EU law.

Regulators should be extremely careful to ensure that some segments of the industry do not ultimately pay for others. Across Europe there is a broad range of investment firms whose activities widely differ and whose cost of supervision will vary depending on whether they are marketing to wholesale or retail investors. The process should therefore be managed in a fair and transparent manner and take as many factors as possible in consideration. We nonetheless appreciate the recognition, in the last paragraph of Article 62a, that *de minimis* thresholds should be introduced to ensure that the smallest market players, which are often only active within their own national borders, are not subject to fees that would be disproportionate compared to their size.

Paragraph 5 of the Article 62a also states that industry's annual contributions shall be collected by authorities that will be designated by Member States as those responsible for verification of calculation, as well as the enforcement of contributions' payment. Due to the expected complexity of the contributions' calculation system, the process of verification and enforcement will most likely be complex and cost-intensive. Irrespective of which authority will be responsible for the collection of these new contributions from financial institutions, they are likely to require additional resources to meet this responsibility.

Given that the proposed new funding model marks a fundamental change in philosophy, it is also essential that the current governance and accountability structures are made more robust in order to guarantee the legitimacy, efficiency and necessary oversight of the ESAs. An appropriate level of transparency around the ESAs funding model should also be ensured. Finally, as we understand that in some countries the industry is already indirectly financing ESAs when contributing to the budget of their national competent authorities, mechanisms should be put in place to ensure that the new direct contributions to ESAs off-set these existing contributions.

IV. Direct supervisory powers *(EUVECA and ELTIF Regulations)*

While Invest Europe recognises that standardised supervisory practices and an increased role ESMA could ensure better harmonisation and supervisory convergence (including tackling Member States practices regarding the imposition of host fees and charges), we also see many disadvantages of the Commission proposal, which in some cases may outweigh its benefits.

Among the direct powers granted to the Authority under the new proposal, ESMA is entrusted with the functions of authorisation/registration and supervision of the EuVECA and ELTIF funds. This change not only substitutes national competent authorities for ESMA as the main point of entry for these managers, but also lays down additional, new powers for ESMA to regulate managers who voluntarily seek this passport for their funds.

We have several reasons to believe the proposed approach might undermine the Commission's objective of improving the attractiveness of EuVECA and ELTIF passports for small venture capital managers. It is in particular not certain whether direct supervisory powers given to ESMA would effectively "lower transaction and operational costs" of the manager, one of the expected objectives of the Commission review[1]. We are especially concerned that the role given to ESMA could make the existing authorisation or registration processes more burdensome for fund managers and create barriers to entry for the smallest. The proposed change could also lead to many (legal) uncertainties, in particular where a fund manager is marketing both EuVECA and non-EuVECA funds, which could ultimately disincentive them from using the EuVECA label.

It should also be noted that a better supervisory convergence and harmonisation of EuVECA requirements could be achieved under the existing framework and potentially further enhanced by the proposed changes to the ESAs governance, as mentioned in section I of this paper.

1. Risks of duplicating supervision

Depending on whether the fund manager of the EuVECA is only registered or fully authorised under the AIFMD – either because it exceeds the threshold set out in the AIFMD or because it chose to opt-in to the regime – the proposed amendments might have different implications.

- **Managers registered under the AIFMD**

In line with Article 3 paragraph 3 of AIFMD, fund managers "whose assets under management in total do not exceed a threshold of EUR 500 million when the portfolios of AIFs consist of AIFs that are unleveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF" ("sub-threshold managers") are only required to register with their national competent authority and are exempt from most AIFMD's requirements. However, Member States may impose additional and more stringent national rules on these fund managers and on their funds.

Under Art 14.5 of the revised EuVECA Regulation, a registration to its national competent authority in respect of the management of the EuVECA fund will be deemed equivalent to an AIFM registration under Article 3 paragraph 3 of AIFMD. In line with the approach proposed in the ESAs Review, ESMA would therefore become the responsible authority for the registration of new sub-threshold managers when these are marketing EuVECA funds.

This creates difficulties and uncertainties for both *existing* EuVECA managers that manage EuVECA and non-EuVECA funds as well as for new fund managers wishing to use the EuVECA label. In those two cases, it appears the fund manager may have to be registered and/or supervised both by ESMA and by the national competent authority, while at the moment they are only in contact with the latter. This will ultimately make the application of the EuVECA passport more complicated and undermine the Commission's objective of making the EuVECA passport more simple and more attractive.

[1] The subsidiarity statement accompanying the Commission proposal mentions that the single supervision will "decrease the amount, and diversity, of costs and time spent on administration and will thus allow managers to lower transaction and operational costs"

- **Managers authorised under the AIFM**

Alternative investment fund managers with more than EUR 500 million of assets under management need to be authorised under Article 6 of AIFMD by their national competent authority, which will be responsible for their supervision.

As part of the proposed review (new Article 18 of EuVECA), ESMA will become the sole supervisor of the EuVECA fund and will ensure its compliance with EU rules, whether they are set in EuVECA (e.g.: fund registration), AIFMD or the relevant national legislation implementing the Directive. However, the national competent authority remains the supervisor of the fund manager in respect of AIFMD requirements not related to the EuVECA fund.

Considering that a fund manager may market both EuVECA and non-EuVECA funds, its activities may therefore be supervised by:

1) *ESMA*: when it comes to EU-related requirements in respect of its EuVECA fund
2) *its national competent authority*: for requirements in respect to:
    a. its fund management activities
    b. its non-EUVECA funds
    c. all other national laws applying to the fund

We believe this approach creates a great amount of uncertainty for the fund manager, in particular if it markets two types of funds, and could lead to additional costs.

- **Consequences**

While there is a lack of clarity as to how ESMA will ensure EuVECA funds are compliant with their national rules, we fear that a significant amount of resources will be required for ESMA to develop first-hand experience and understanding of how the AIFMD and other relevant Directives were implemented into Member States' jurisdictions where EuVECA funds are based (at the moment 17 jurisdictions). This could in turn impact the size of the supervisory fee that ESMA feels obliged to levy on EuVECA managers, and therefore make the passport more costly and less attractive.

Moreover, the proposed approach could create cases where ESMA and the national regulator will find themselves in a situation where *both* of them will have competences to supervise some activities that would relate to both the fund and its manager – especially in Member States where the fund is not recognised as a legal entity[2]. Ultimately, a fund manager may be in a position where it would receive diverging requests from both its national authority and ESMA, leading to legal uncertainty and delays.

In a number of jurisdictions, there is also specific domestic law and regulation of the fund vehicle. In some Member States, the regulation of collective investment undertakings which are not offered to retail investors (covering most private equity funds) is essentially passive. However, a national competent authority will be able through its supervision of the manager also to supervise the operation of the fund vehicle to ensure that it is consistent with applicable law. In other Member States, the fund vehicle is itself authorised under domestic law and subject to supervision by the same competent authority as the manager. Certain Member States have fund vehicles of both types.

In most countries there will also be securities offering laws restricting the offering of AIFs to retail investors. In addition, some Member States impose domestic rules about the fitness and propriety of individuals working for a regulated firm. Wherever domestic laws and regulation are applicable to a fund, giving

[2] In such Member States, any activity of the fund is likely to be regulated as an activity of the fund manager, given the fund does not have any legal personality

additional direct supervisory powers to ESMA will either lead to duplication of effort (because ESMA must supervise the manager for harmonised matters and the national competent authority must supervise non-harmonised matters) or will, again, require ESMA to develop expertise in the relevant domestic law and regulation of each Member State. In our view, this is also likely to impose a heavy burden on ESMA and is inconsistent with the principles of subsidiarity and proportionality.

2. Risks for smaller managers

Existing relationships between fund managers and their national competent authorities generally work well and allow for useful and regular discussions. Under the current framework, managers are often able to meet their local regulators face-to-face in order to understand the application of the rules to them in an efficient manner.

There is some concern among our members that ESMA might be less accessible than their current supervisors, which could in some cases lead to additional administrative burdens for smaller players and have some impact on their operations. There are perhaps potential ways in which ESMA could mitigate this, for example by establishing new ESMA offices in Members States – however, this would be costly and ultimately lead to a further increase in regulatory fees imposed on market participants.

Moreover, as typical venture capital managers will often have less than 10 employees, they will in most cases use national/local law firms to help them register their funds to their national competent authority. With ESMA being the competent authority of these funds, these funds' managers may need to hire in the future more international advisory firms with a better experience/understanding of the EU regulatory environment – something that may ultimately raise their registration costs. This risks raising the barrier to entry for smaller fund managers, which seems to go against the objectives of the Capital Markets Union.

V. Outsourcing and delegation *(Article 31a of ESMA Regulation)*

The new Article 31a suggests that ESMA should be given additional powers when it comes to the coordination of delegation and outsourcing of activities by financial market participants. It also allows the Authority to carry out a separate and specific assessment of their activities based on the information it will have received from the national competent authority and the financial market participant.

Delegation and outsourcing arrangements, to EU or non-EU jurisdictions, as well as other cross-border arrangements which do not fall under the definition of delegation, are important for the private equity industry, not least because private equity funds by nature almost always operate on a cross-border basis. Such arrangements enable fund managers to access the skills and expertise they need in the most efficient manner and without having to move people unnecessarily. Given that investments are sometimes made all over the world, that private equity teams are very often located in different countries, and that investors themselves will also be dispersed across Europe and the wider world, such delegation arrangements allow private equity managers to access other markets – such as the United States - without having to set up completely new structures.

Delegation and outsourcing in private equity industry is not driven by regulatory arbitrage, but by a range of legitimate reasons for delegating a task, such as:

- the delegate having staff with investment expertise in relation to particular investments to be made by the AIF (this expertise might relate to an industry sector (e.g. pharmaceuticals), investment type or geographical location);
- the delegate having administrative expertise such as legal, accounting or regulatory expertise which is relevant for administrative services;

- the delegate having marketing expertise and/or potential contacts of use to the AIF, the manager and/or portfolio companies

While we recognise the importance of ensuring consistency in the application of EU rules, we are of the view that an additional layer of supervision is neither necessary nor proportionate in this case and fails to meet the EU subsidiarity test. We also note that the proposed change could create significant additional legal uncertainty for cross-border arrangements which do not fall under delegation but still might be subject to additional scrutiny of ESMA on the basis of new Article 31a, para 2.

Such a change risks making existing registration and authorisation processes more burdensome and bureaucratic than they currently are. It should be noted that delegation arrangements are already regulated under strict EU rules (Article 20 of AIFMD and relevant Level 2 provisions for alternative investment funds) and significant effort is already required from the market participant to comply with rules set by the national regulator based on the relevant EU law. ESMA's involvement would further complicate the existing procedure, resulting in an extension of the length of the registration process and in an increase of legal uncertainty for managers seeking to be authorised. Consequently, they may not be in a position to exercise their business activities until the authorisation process is complete.

Moreover, once an authorisation is granted, the ongoing assessment with respect to delegation will typically require a close and regular review of the manager by national regulators and a constant exchange of documents between the manager and its authority. Further ESMA oversight will make the existing process even more complex than it currently is.

We also believe ESMA already has appropriate tools and measures to ensure supervisory convergence and that future changes to its governance structure suggested in this review will reinforce ESMA's ability in that regard.

Contact

Thank you in advance for taking our comments into account as part of the negotiation process. We would be more than happy to further discuss any of the comments made in this paper.

For further information, please contact Christophe Verboomen (christophe.verboomen@investeurope.eu) at Invest Europe.

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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