INVEST EUROPE

Invest Europe Comments

on Finanstilsynet's AIFMD Q&A Items on Leverage

With this note we would like to comment, on behalf of the whole European private equity and venture capital industry, on Finanstilsynet's indicative statement on the inclusion of leverage in unlisted companies and issuers by managers of alternative investment funds, as an interpretation of Article 6.3 of the AIFMD Delegated Regulation.

Our firm view is that the proposed Q&A:

- is **not in line with the EU law** it is deemed to interpret ("legal argument")
- will create **confusion as to what is effectively leverage** ("economic argument")
- diverges significantly from **other national interpretations** ("coherence argument")
- risks **affecting disproportionately the Danish market** ("competitiveness argument")

We would therefore call on Finanstilsynet to adapt the Q&A in a way that would take into account the comments made below. We propose some specific suggestions in the attached Annex.

At the same time, Invest Europe – along with Active Owners - would be glad to engage with Finanstilsynet to better understand what the reasons behind the drafting of this Q&A are – and whether the industry can give further reassurance of the relevance of existing AIFMD rules. This response is complementary to the separate response given by Active Owners.

Introduction: the relevance of Article 6.3 and of its interpretation

> ***AIFMD Delegated Regulation Article 6.3*** *- Exposure contained in any financial or legal structures involving third parties controlled by the relevant AIF shall be included in the calculation of the exposure where the structures referred to are specifically set up to directly or indirectly increase the exposure at the level of the AIF. For AIFs whose core investment policy is to acquire control of non-listed companies or issuers, the AIFM shall not include in the calculation of the leverage any exposure that exists at the level of those non-listed companies and issuers provided that the AIF or the AIFM acting on behalf of the AIF does not have to bear potential losses beyond its investment in the respective company or issuer.*

Some private equity strategies, such as the one carried out by buy-out managers, will often involve **leverage at the "portfolio company" level**. Private equity-backed companies borrow from banks and from other capital market participants just like other corporates (they often benefit from more diversified sources of funding than similarly sized companies given their experience in seeking out alternative sources of capital).

- From a financial stability perspective, the **borrowing at the level of the portfolio company will have no bearing on the leverage of the fund** (if there is any).

The debt held by each of a buy-out fund's individual portfolio companies is ring-fenced from any debt of the fund itself and of any other portfolio company controlled by the fund.

- This legal and economic separation is an **essential feature of the private equity model**.

This, along with a series of other factors, distinguishes the private equity model, which is about temporary equity minority or majority ownership, from corporate ownership that can be seen within trade groups.

- This has important implications from a risk exposure perspective

"Portfolio company" level leverage is, however, typically made available to a holding company in **the acquisition stack** of the portfolio company. Any counterparty (a bank, for example) that lends to a portfolio company either directly or at the level of a holding company in an acquisition stack is **only exposed to the operating companies in the portfolio company structure**. It is not exposed to, nor does it have recourse to, any fund that owns shares in the holding company or other investments held by the fund.

- In the same way **the bank would not have recourse to a listed company** where it had used a holding company for an acquisition.

If the holding company were to default (in either the private equity or listed corporate ownership scenario), the bank would exercise its security and potentially become the owner of the *operating group* (i.e. of the underlying assets in the holding company and the operating company). Most importantly, it would not have recourse to the fund or listed company or the investors of such entities.

- In a private equity case, the **maximum loss for the fund would be limited**, as always, **to the amount of equity it had invested** in that specific holding company.

Such failures have no bearing on other investments made by the fund because there is no borrowing between portfolio companies nor is there any recourse to the fund.

In other words, any debt incurred by a private equity-backed portfolio company (including its holding company) should be seen, from an economic risk perspective, as the debt of this company and not the debt of the fund.

Article 6.3 AIFMD Delegated Regulation was created for the very purpose of making this distinction. Without Article 6.3, any equity investor in businesses could be seen as leveraged for the sole reason the business it has invested in is leveraged. In a simplified manner, this would be equivalent of saying that any investor is in a leveraged position because it holds shares of an indebted company.

It is worth pointing out that this exception, which is currently specific to private equity, is one that should effectively apply to any structure with the same characteristics.

Exceptions

The description made above does not preclude that there may be **certain borrowing arrangements under which** the debt of the portfolio company could **directly increase the exposure of** the fund. One obvious example of this is **if the fund itself guarantees the portfolio company debt**. In that case, it is clear that the leverage of the company could have a direct impact on the fund – and on other businesses within the fund. Yet, **these exposures would then (and should) be excluded from the exemption set in Article 6.3**.

1. Legal argument

In Art. 4(1)(v) AIFMD, leverage is defined as "any method by which the AIFM increases the exposure of an AIF it manages". This has been clarified in Article 6.3 AIFMD Delegated Regulation, which again has been clarified in several Q&As. In our opinion Finanstilsynet's interpretation as set out in its proposed Q&A does not fit with the logic of Art. 4(1)(v) AIFMD, Article 6.3 AIFMD Delegated Regulation and the subsequent interpretations.

In ESMA's Q&A, Section VII, Q&A 1, ESMA confirms that a private equity fund does not need to include debt raised at the level of a "financial structure that is used to acquire non-listed companies or issuers" (e.g. a SPV), where the AIF does not have to bear losses beyond its investment in such financial structure (i.e. the financial structure is not "specifically set up to directly or indirectly increase the exposure at the level of the AIF").

The Danish FSA does not distinguish between the fact that an AIF has to bear losses beyond its investment in such financial structure or not. It however considers any borrowing at the level of an intermediary SPV as leverage of the AIF because "the SPV functions as a structural entity designed to increase the AIF's overall exposure".

This view is not correct because, without bearing the risk of the borrowing at the level of the SPV, the **AIF's exposure is not further increased but limited to its investment in the SPV**. In other words, the position of Finanstilsynet presumes, without any evidence, that any SPV borrowing is by nature increasing the exposure of the fund. This is not at all the logic of either the rules in the AIFMD Delegated Regulation and of the ESMA Q&A.

This view is shared by all lawyers that we have consulted in our Legal and Regulatory Committee and, as we will mention in the third section, by other NCAs in the EU. We therefore consider that the proposed interpretation goes beyond the requirements of the AIFMD, some lawyers arguing it would breach the AIFMD rules (see our comments on section 3).

Beyond the interpretation of the legal text, the European Commission expressed its objectives informally, at the time the rules were crafted in the following way (translation of an email in German):

*"The key consideration […] is **whether the AIF or the AIFM acting on its behalf must cover potential losses that exceed its investment in the relevant company or issuer**. In other words, as soon as the AIF or the AIFM acting on its behalf is contractually obliged to bear losses of the acquisition vehicle (holding company) or of the acquired company, such potential losses (debts) must be included in the calculation of leverage. If this is not the case, then the AIF/AIFM, for example, does not have to account for potential loan losses, even if such loans serve to finance the acquisition.*

This information is provided without prejudice to the work of my colleagues on the implementation of the recommendations of the Liikanen Group and serves solely to interpret Article 6 of the aforementioned delegated regulation"

This suggests that Finanstilsynet's proposed interpretation is not in line with the objectives of the text.

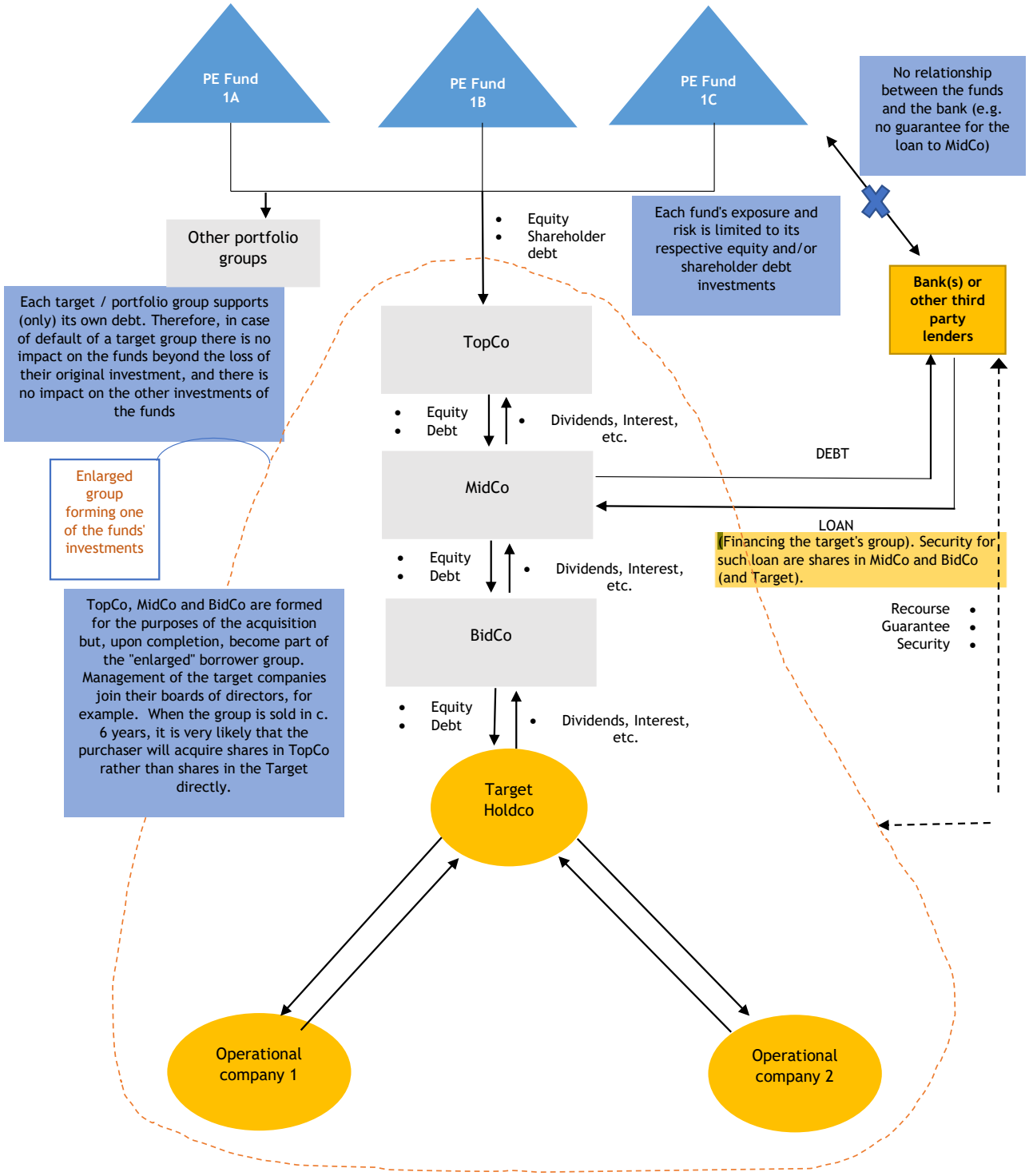
2. Economic argument

We do not think that the proposed Q&A accurately reflects the way private equity managers structure their deals including the nature of leverage used in a private equity context, how it is typically calculated and the risk that it poses.

The "structure chart" Finanstilsynet has added to its proposed Q&A is not an appropriate representation of the way private equity managers structure their deals and the debt that might be attached to such deals. By simplifying what is arguably a complex structuring, it is missing some important elements.

Most importantly, as mentioned in our introduction, the proposed Q&A wrongly captures together debt of the fund and the SPV as being connected. However, in practice, the debt of the Holdco and of the Opco are separated from the fund.

We find the below diagram gives a more accurate representation of typical structures (although there will of course be differences from fund to fund, this model is by far the most representative one in the industry).



As can be seen from the diagram, and importantly from a financial stability perspective, the **borrowing at the level of the portfolio company does not automatically have, as suggested by Finanstilsynet, any bearing on the leverage of the fund.** The debt held by each of its individual portfolio companies is ring-fenced from any debt of the fund itself and of any other portfolio company

controlled by the fund. This legal and economic separation is an essential feature of the private equity model and distinguishes it from corporate ownership that can be seen within trade groups.

Any counterparty (a bank, for example) that lends to a portfolio company (typically at the level of a holding company) is effectively exposed to the operating companies in the structure. There is no exposure to, nor does it have recourse to, any fund that owns shares in the holding company. If the holding company were to default, the bank would exercise its security and potentially become the owner of the *operating group* (i.e., of the underlying assets in the holding company and the operating company). Most importantly, it would have no recourse to the fund or the fund's investors.

In a private equity case, the maximum loss for the fund would be limited, as always, to the amount of equity it had invested in that specific holding company. Such failures have no bearing on other investments made by the fund because there is no borrowing between portfolio companies nor is there any recourse to the fund.

The description above **does not preclude that in certain specific circumstances the debt of the portfolio company could have an impact on the fund**. This could include situations where a fund is guaranteeing the debt of the portfolio company and, in such situations, it is correct that such debt should be captured by the calculation of fund level leverage.

Finanstilsynet's proposed Q&A therefore does not solve a problem – as mentioned above, the current rules **already account** for the risk of underlying SPVs **may increase** the funds' exposure - but rather creates a problem, by creating some confusion that exposures within SPVs **necessarily** increase the exposure of the fund.

Background: Why isn't HoldCo leverage AIF leverage?

Holding company structures are a common feature of corporate organization and financing, used by the private equity industry and by other corporate entities. These HoldCos are designed precisely to ensure clear legal and economic separation, which ensures that any leverage entered into by the HoldCo is distinct from that of the fund. A holding company that has private equity investors borrows on the security of its subsidiaries, its assets, its business and its revenues. This no different to how any other corporate holding company might raise finance.

If the HoldCo were to default, the bank would exercise its security and potentially become the owner of the *operating group* (i.e. of the underlying assets in the HoldCo and the OpCo). Most importantly, it would not be able to revert to the fund or the fund's investors.

In the case of private equity, the maximum loss for the fund ***would be limited, as always, to the amount of equity it had invested in that specific holding company***. Such failures have no bearing on other investments made by the fund because there is no borrowing between portfolio companies nor is there any recourse to the fund.

In conclusion, a loan entered into by the HoldCo neither *legally* nor in *economic effect* increases the exposure of the fund. Treating it as leverage, as Finanstilsynet suggests, would create ***a misrepresentation, as the HoldCo does in effect not contribute to fund leverage***.

Why are the HoldCo and the OpCo a single Unit?

The HoldCo is clearly separate from the Fund, but should be seen as inextricably linked to the Operating Company (OpCo). Although legally separate, a HoldCo and OpCo form a single economic unit, with lending undertaken by the *former* guaranteed by the assets of the *latter*. Any debt at the level of the holding company is only

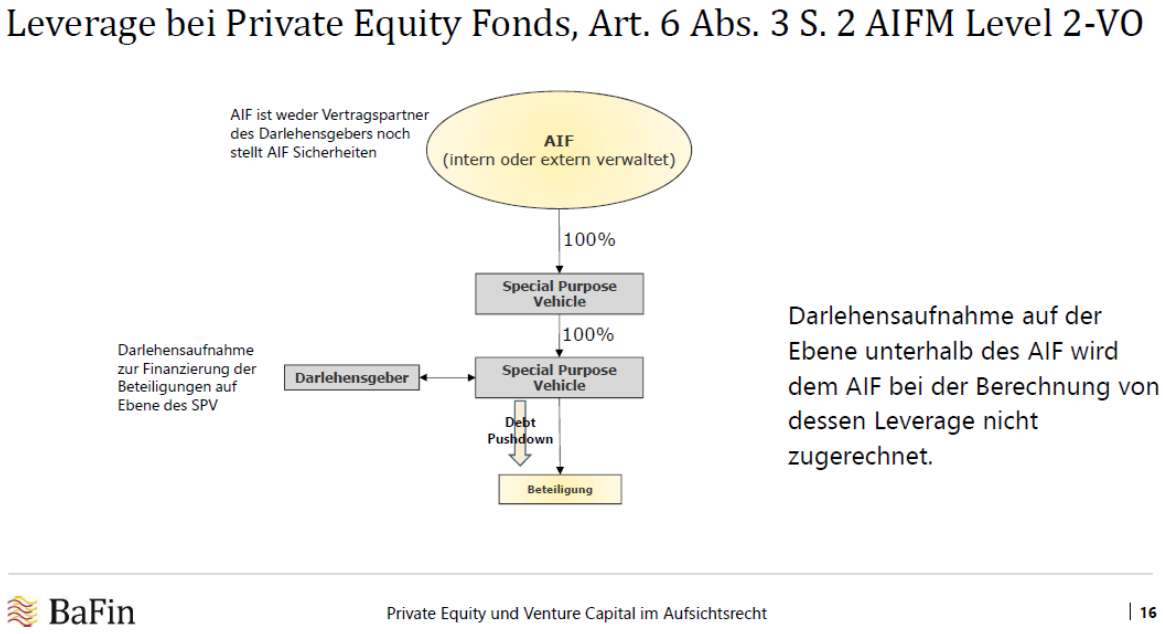
guaranteed by the security of its own specific (OpCo) subsidiaries, assets, business and revenues. Together these two entities form the 'portfolio company'.

Most importantly, and as opposed to other AIFs, in the vast majority of cases the HoldCo and OpCo will, after the purchase is complete, be formally merged, creating a single entity.

3. Coherence argument

To our knowledge, none of the other NCAs have taken a position similar to the one taken by Finanstilsynet in the proposed Q&A. On the contrary, some large NCAs, such as BaFin or the Dutch AFM, have taken different, and arguably more sophisticated, interpretation in compliance with EU law as seen below.

Here is for example the way BaFin describes the issue:



4. Competitiveness argument

Any re-interpretation of the relationship between the fund and any holding companies or SPVs will have significant implications on the Danish market and on the Danish regulator.

First, if holding company or SPV debt were to start being reported, this would have a direct impact on the number of funds that would find themselves above the AIFMD threshold (which is five times lower for leveraged funds). A significant number of smaller Danish private equity funds would therefore become subject to the full AIFMD regime despite not using leverage at fund level. Such funds would become subject to obligations such as more detailed and more frequent reporting despite the fact these obligations are disproportionate in light of their activities. This would make the Danish industry much less competitive against other EU member states.

Second, and perhaps most importantly, reclassifying these non-exposed funds as leveraged would also have a series of implications on fundraising opportunities. For example, the risk charge for insurers committing capital into closed-ended funds is based on their lack of leverage use.

Third, fund managers that are already fully regulated could face additional obligations specific to managers of substantially leveraged funds. This would require them to comply with more complex and burdensome reporting requirements that do not accurately reflect the actual risks they pose. Such an outcome would run counter to the broader political objectives of the Savings & Investments Union, which aims to enhance EU competitiveness through the adoption of more balanced and targeted regulations. The impact of the change of rule would likely be felt most acutely by mid-sized fund managers with hybrid strategies (for example a manager with three funds, one labelled venture, one growth and one buy-out). It would go against the very principles of the Savings & Investments Union. The legal uncertainty that would be generated for these funds followed by the significant additional costs of AIFMD compliance would have a marked negative impact on their capacity to invest in the SMEs that they are currently supporting (83% of the companies supported by private equity funds in 2024 were SMEs).

Therefore, the impact of the proposed Q&A could therefore have **massive consequences on the Danish market**, making it significantly less competitive than its EU counterparts.

As background, our data shows the Danish venture and growth market, most likely to be affected by the changes of rules, is also struggling against its Nordic counterparts. Since 2020, Danish venture and growth fund managers raised € 1,9 billion against € 2,8 billion in Finland, € 6,4 billion in Sweden and € 7,1 billion in Norway[1]. The situation could worsen further if Danish small and mid-sized buy-out managers would become automatically AIFMD regulated due to a change of rule.

As a final argument, Finanstilsynet should also consider the consequences for the quality of its monitoring if it started to consider as "leveraged" the use of debt that does not effectively increase the exposure of the fund, as we demonstrated in this note. It would be misleading to require the exposure to be reported on a consolidated basis where the holding company or SPV borrowing is effectively ring-fenced from the fund. Doing so would neither take into consideration the real risk the fund itself poses, nor that the lending risk to the underlying exposure will be captured under relevant prudential legislation, in the same way as any other private company with the same intrinsic characteristics. It would also mislead Finanstilsynet in thinking that there is cross-collateralisation between the companies in which the fund invests despite the fact that the debt of one portfolio company is not dependent on the debt of another.

For Invest Europe

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Public Affairs Director

[1] Invest Europe/EDC Activity Data, 2024, Fundraising statistics.

ANNEX

If you are convinced by the arguments above, we wanted to share some amendments to the proposed Q&A that would reflect these arguments

Q&A Items - Leverage

What is leverage under the AIFM regulation?

~~All m~~Methods used to increase the exposure of an investment are defined as leverage, cf. section 3(1)(29) of the Danish AIFM Act (*FAIF-loven*). Leverage may be loan-based but can also arise through financial products such as derivatives.

Leverage means that the exposure to one or more specific investment opportunities is increased. By using leverage, the potential return is increased, but this also entails a higher risk and thus larger losses during periods of negative market developments.

Should exposure contained in a financial or legal structure be regarded as leverage — for example, leverage in an underlying company owned by the fund?

It is not decisive whether the method that increases exposure lies within the AIF itself or within intermediary entities, cf. Article 6(3), first subparagraph of the Commission Delegated Regulation. Therefore, exposure contained in financial or legal structures must also be included when such structures are developed with the purpose of directly or indirectly increasing exposure at the AIF level, and where the AIF controls the financial or legal structure.

On 17 December 2024, Finanstilsynet published a guiding statement in connection with an update to ESMA's Q&A. Read more here.

Should exposure in unlisted companies/issuers be regarded as leverage?

The general principle that exposure within legal and financial structures must be included also applies to situations where the exposure lies in unlisted companies and issuers. However, Article 6(3) ~~, second subparagraph of~~ the Commission Delegated Regulation contains a narrow exemption.

An exposure in unlisted companies and issuers is not included if:
i) the AIF's ~~fundamental~~ **core** investment policy is to acquire control of unlisted companies or issuers,
ii) any such exposure exists at the level of those unlisted companies or issuers, and
iii) the AIF or its manager acting on behalf of the AIF is not required to bear potential losses beyond its investment in the relevant company or issuer.

~~For unlisted companies and issuers, this refers to *target companies* and not intermediary entities (Special Purpose Vehicles or SPVs), even if the relevant SPV is an unlisted company.~~

The exemption should be viewed in light of the fact that **such** an unlisted **company or issuer** ~~*target company*~~ will often **enter into borrowing arrangements or** have balance sheet financing, e.g. for operational **or strategic** purposes. The definition of leverage could technically mean that such **arrangements or** financing would be regarded as leverage. However, where **these arrangements or** financing do not increase the AIF's **own** exposure, **for example, because the AIF has not guaranteed the loan to an unlisted company or issuer**, ~~as it merely reflects the company's capital structure and the value being acquired~~ **such exposure should not be included in the AIF's own leverage calculation.**

The acquisition of shares in an unlisted ~~target~~ company **or issuer** is therefore generally **not considered leveraged**. ~~This also ensures equal treatment of investments in listed and unlisted shares/interests.~~ The acquisition is only considered leveraged if a method is used to increase exposure **at the level of the AIF** — for example, through borrowing or the use of derivatives to finance the share acquisition.

~~The exemption does **not** cover loan financing used to acquire the target company, e.g. through borrowing in an intermediary SPV. Such loan financing falls under the first subparagraph of the provision, even if the SPV is an unlisted company. In these cases, the SPV functions as a **structural entity** designed to increase the AIF's overall exposure and not as the final investment target.~~

Should a temporary loan agreement be regarded as leverage?

Loan agreements entered into by the AIF are excluded if they are **temporary in nature** and relate to and are **fully covered by investor capital commitments**, cf. Article 6(4) of the Commission Delegated Regulation. Revolving credit facilities, overdraft facilities, etc. are generally **not** considered temporary in nature.

However, Finanstilsynet considers that limited use of an overdraft facility — for example, to cover administrative expenses due to liquidity timing differences — ~~should likewise~~**need** not be included **as a relevant** exposure **provided** ~~However, this presupposes that~~ the use of the overdraft facility is temporary in nature and that it would only in a very limited way increase the exposure if its value were included. **This would be the case even if the overdraft facility is not fully covered by investor capital commitments.**