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

Response to the ESMA Consultation Paper on draft regulatory technical standards under Article 25 of the ELTIF Regulation (cost disclosure)

Introduction

The European private equity industry appreciates the opportunity to respond to the ESMA Consultation paper on the draft regulatory technical standards ("RTS") with regards to cost disclosure requirements applicable to ELTIF managers under Article 25 of the ELTIF Regulation.

While we support European legislators' efforts to ensure investors are in possession of the appropriate level of information before investing into ELTIF-labelled funds, we are concerned that elements of the draft RTS could have unintended (and adverse) consequences for ELTIFs marketed by private equity fund managers, creating confusion for these investors. Concerns laid out in our responses below mostly relate to the characterisation and treatment of carried interest as 'costs' to be borne by ELTIF investors.

Carried interest is an intrinsic feature of private equity funds, the purpose of which is to align the interests of investors and the fund manager. It acts to incentivise fund managers by enabling them to participate in a share of the profits of the fund as a whole. In the private equity model, there is no guarantee that a fund manager will ever receive any carried interest payments. A fund manager is generally only entitled to receive a share of the fund's profits:

- *after* investors have had returned to them the **value of their commitments** drawn down by the fund; and
- provided investors have *also* received the **agreed preferred rate of return** on their investment.

A fund generally does not even begin to accrue carried interest until several years into its, typically, 10 year life (it is indeed unlikely the fund will have any profits in the early years of the closed-end fund).

While carried interest is not listed specifically in Article 25 of the ELTIF Regulation, point 5 of Article 1 of the draft RTS makes clear it would have to be included within the presentation of costs. Moreover, unlike in the PRIIPS Delegated Regulation (which appears to be ESMA's reference in this case), carried interest is not treated separately from performance-related fees in the proposed Annex to the draft RTS. According to such an Annex, carried interest may have to be presented as a yearly cost and as a percentage of the capital. As our description of carried interest above indicates and for the reasons detailed in our response to Q3, we believe that (a) carried interest should not be presented as a cost and (b) the amount calculated under the proposed approach would not be representative of the real impact of carried interest on the investors' returns.

In order to avoid creating confusion, we would like ESMA to remove any reference to carried interest from the RTS, as it is not a fee and cannot in any case be calculated as a percentage of the capital.

At the very least, we believe ESMA needs to introduce clarifications to ensure that the investor is not misinformed or misled by the proposed presentation of costs. ESMA could easily do this by taking the example from the description set in Table 2 of Annex VII of the KID-PRIIPs Regulation.

Finally, we would like to express our general concerns regarding the current approach towards cost disclosure in EU law. The overarching goal in the past few years has been to present the investor with information as simply as possible to allow the investor to make an informed decision.

While this objective is laudable, we fear this has created misunderstanding due to the rigidity of the system. For more complex products, it is clear that such rigidity has caused investors to be given misleading information. A good example of this is requiring a private equity manager to calculate carried interest based on historical data of other funds, and to then present it as part of the general costs of the fund. We would advise policymakers to better take into account in the future the specificities of different fund products and existing market practices within disclosure documents (for example, by describing certain models rather than giving an absolute number or percentage).

It is worth pointing out as a conclusion that the risk of confusion we describe above could greatly be diminished, at least from a private equity perspective, by ensuring that only *true* retail investors receive an ELTIF prospectus or a KID. While private equity managers extremely rarely market their funds to *true* retail investors, they do offer their products to *sophisticated* investors, such as high net worth individuals and family offices. We have long argued that it made little sense to prepare a document as simple as the KID for such types of experienced investors – which are not retail *per se* and which do not commit capital to a fund in the same way that a true retail investor would. Providing a definition of sophisticated investors and subjecting them to their own set of rules would certainly help in putting their capital to good use.

Q1 Taking into account the new cost disclosure framework introduced by the PRIIPs Regulation, do you agree that the abovementioned pieces of legislation and regulatory material are relevant for the purpose of the RTS on Article 25(3) of the ELTIF Regulation? Which other pieces of legislation and regulatory material do you consider relevant for that purpose?

Yes, we agree that these are relevant pieces of legislation for this purpose.

However, as we explain in further detail in our response to Question 3 below, ESMA should be careful not to rely solely on the UCITS Implementing Regulation. Closed-ended alternative funds may have different characteristics from open-ended funds, such as UCITS, and these would not always have been accounted for in the Implementing Regulation.

Q2 Taking into account the new cost disclosure framework introduced by the PRIIPs Regulation, do you agree with the above mentioned assumptions? In particular, do you agree with the proposal included in paragraph 21 above? With respect to the overall cost indicator, would you see merit in aligning the

PRIIPs level 2 framework on cost disclosure with the level 1 framework on cost disclosure under the ELTIF Regulation (or the other way round)?

While we generally agree with the assumptions presented in this section, we are concerned that carried interest is presented as a type of cost. There is no reference to carried interest (which ESMA clearly distinguishes from a performance fee in paragraph 17 of this consultation paper) in Article 25 of the ELTIF Regulation and we are therefore not convinced it ought to be included within this section.

Moreover, paragraph 2 of Article 25 makes clear that the prospectus shall disclose an overall ratio of the costs to the capital of the ELTIF. As carried interest is a percentage share of the profits of a fund that is only received after investors have received back their commitments and provided a preferred rate of return has been generated on those commitments, it is doubtful that it was the intention of the legislator to cover this as a type of 'cost' within Article 25.

The proposal to treat carried interest as a cost to be compared to the fund's capital would have the perverse consequence that the more successful a manager is in achieving higher returns for investors, the higher the cost number that would have to be presented.

Moreover, it must be reiterated that there is no way to calculate in advance how much will be paid in carried interest over the life of a fund, if indeed any is paid at all. Investors in a private equity fund may receive back *all* their original commitments *and* a meaningful return, without the fund manager receiving *any* carried interest payment at all.

While including carried interest in the notion of "costs" in the context of the PRIIPS Regulation provides retail investors with information on the effective potential return-in-yield to consider before investing in a fund, the same would not apply under the ELTIF Regulation which requires an indication of the ratio between overall costs and capital. Article 2(1) of the ELTIF Regulation defines capital as "aggregate capital contributions and uncalled committed capital, calculated on the basis of amounts investible after deduction of all fees, charges and expenses that are directly or indirectly borne by investors". Treating carried interest as a cost in this context would convey information which is inconsistent with such a definition: carried interest is not an item reducing investible amounts. It also risks being misleading as a fund delivering a *high* return would be associated with an apparently worse cost ratio than a fund delivering a *lower* return, even if the true costs of administering and operating these funds were the same.

Carried interest is a long-standing and intrinsic feature of private equity fund structures and is very much supported by investors. A private equity fund's constitutional documentation sets out in detail the mechanism for calculating carried interest, including the waterfall (or sequence) of how cash proceeds generated by a fund are allocated between investor and fund manager. The information that the fund is operating a carried interest scheme will have been previously disclosed pursuant to paragraph (c) or (i) of Article 23 of the AIFMD, as is required in Article 23 of the ELTIF Regulation. Even if it were not presented in the cost section of the ELTIF, there is therefore no risk that the investor would be unaware of the impact of carried interest on its ultimate return before making a commitment to the fund.

Should ESMA decide to still refer to carried interest as a cost, it should at the very least carefully ensure that carried interest's specific features are acknowledged and addressed in order to ensure that investors do not get a distorted picture of the costs they will face when investing. We detail these features in our responses to Question 3 and 6.

Q3 Taking into account the new cost disclosure framework introduced by the PRIIPs Regulation, do you agree that the types of costs mentioned in the present paragraph are annual costs that could be expressed as a percentage of the capital?

Should carried interest be deemed a cost, as currently suggested by ESMA, we disagree with the idea that all costs should be calculated on an annual basis and as a percentage of the capital.

For a closed-end private equity fund with a typical carried interest structure, trying to calculate the amount of carried interest that might be paid out by the end of the life of the fund, on an annual basis and then showing this "calculated" number as a percentage of capital is meaningless, particularly over the first several years of a fund's life.

While a number could in principle be calculated as specified in point 25 of Annex VI of the PRIIPS Regulation (as suggested in point 7 of Article 1 of the draft Regulatory Technical Standards), we are concerned that under the proposed approach:

(i) it may not be clearly treated separately from performance fees in the presentation of costs, as opposed to the approach taken in PRIIPS (while carried interest share similar features to performance fees, it also has very different characteristics which are detailed below);
(ii) it will have to be calculated yearly;
(iii) it will have to be calculated as a share of the capital of the ELTIF.

Due to the structure of the private equity carried interest model, calculating carried interest as an annual cost expressed as a percentage of the capital would give results that are at best misleading and that would not give the investor an appropriate overview of what the actual cost of investing in an ELTIF private equity fund is.

- <u>Carried interest is not a share of the capital</u>

Carried interest is an agreed percentage of the net profits of the fund, the total amount of which is only known at the end of the life of the fund. There is no relation between the carried interest and the share capital of the fund.

The mechanism is specifically designed to align the interest of the fund manager and its investors and to incentivise the fund manager to focus on the long-term performance of the fund as a whole. Carried interest is only generated if and when investments are realised and cash proceeds have been returned to investors to repay their commitments that have been drawn down by the fund and provided the preferred rate of return agreed with the investor at the outset has been achieved.

This model is used in the private equity industry because what is important to investors is the performance of a private equity fund as a whole.

- <u>Carried interest is only paid after commitments have been returned and provided a "preferred rate of return" has been achieved</u>

Fund managers and investors agree the detailed terms of the carried interest arrangement at the outset and these are detailed in the fund's documentation. This agreement will include the percentage share of the total net profits of the fund to which the fund manager would be entitled (typically 20%); the preferred return percentage rate (typically 8% per annum) at which point the carried interest will begin to accrue; and the "waterfall" setting out the order in which cash proceeds received by the fund are allocated between investors and the fund manager.

There is, therefore, no guarantee that *any* carried interest will *ever* be earned and paid to the fund manager: if the fund does not return the money paid in by its investors and achieve the preferred rate of return <u>there will be no carried interest payment to the fund manager</u>.

This also means that carried interest cannot be accurately calculated until the fund is fully realized. As a result the carried interest model contradicts the assumption in paragraph 23 that the duration of the investment is not necessary for the calculation.

- Carried interest is typically not paid each year

The details of the carried interest arrangements are agreed at the outset of the fund, but as explained they are applied to the net profits of the fund as a whole, with the definitive amount only being known when the fund is fully realized. There is no concept of carried interest being linked in any way to the annual performance of the fund. In practice, in a ten-year life fund (the typical length for a European private equity fund), carried interest typically only starts to be generated several years into the life of the fund as the investments made in the early years of the fund's life start to be realized. In the first few years of a fund's life, it is therefore the norm that there is no carried interest generated by the fund.

For the reasons outlined above, presenting carried interest as a yearly share of the capital and as a type of performance fee would be very misleading and may bear no relation to the actual outcome that will only be known with certainty at the end of the fund's life.

Moreover, this number could be confusing for the investor as the private equity fund's documentation will also set out in detail the mechanism for calculating carried interest, including the waterfall (or sequence) of how cash proceeds generated by a fund are allocated between investor and fund manager. This provision of the legal agreement between fund managers and investors is a more accurate description of the impact carried interest would have on the investor's returns.

In order to avoid this situation, carried interest should, if presented at all in this section of the prospectus, be presented separately as a specific charge, shown as a percentage of *net profits* as opposed to as a percentage of the *capital committed* by the investor, and not on a yearly basis. As explained in our answer to Q6, it should also be possible for the manager of the ELTIF to show that carried interest is only paid provided the agreed preferred rate of return has also been achieved.

Q4 Taking into account the new cost disclosure framework introduced by the PRIIPs Regulation, do you agree that the types of costs mentioned in paragraph 24 are fixed costs and that an assumption on the duration of the investment is necessary to calculate these costs in the numerator of the overall ratio mentioned in Article 25(2), provided that this overall ratio is a yearly ratio?

N/A

Q5 Taking into account the new cost disclosure framework introduced by the PRIIPs Regulation, do you agree that the types of costs mentioned in paragraph 27 may be considered as fixed costs in the case of an ELTIF?

N/A

Q6 Do you agree with the views expressed in paragraph 28 on the presentation formats of the costs in the context of the ELTIF cost disclosure?

While the CESR's template for the KIID can be used as a basis, we believe it fails to take into account models that are used beyond the UCITS world. This is particularly true for the private equity carried interest model, which is unsurprisingly absent from the presentation of costs of UCITS given:

(1) carried interest, as it is described in this response, is a typical feature only of private equity funds, virtually none of which are UCITS;

(2) UCITS are open-ended funds while the private equity carried interest model is established on the fact that the funds are closed-ended;
(3) carried interest is a share of total net profits of the fund and so not a cost *per se* and should arguably not be covered in this section.

In order to avoid a misrepresentation of the costs entailed by carried interest, while ensuring the investor is aware a share of its profits will be given to the carried interest participant above a certain return, we would have a strong preference for carried interest not to be presented in this section at all.

However, should this not be possible, we would like ESMA to present carried interest separately from performance fees - and for the description to contain caveats that make clear it is a percentage share of the total net profits of the fund and that it will only be paid if and when the fund has met the criteria clearly set out in the fund's constitutional document. Table 2 of Annex VII of the KID-PRIIPs Delegated Regulation, which already reflects these characteristics, would be much more appropriate to use in that regard than the UCITS Implementing Regulation (although we disagree with the premise that carried interest should be "estimated" based on historical data of peer funds).

Moreover, the presentation format does not yet take sufficiently into consideration the different cost levels in case of multiple share/unit classes in an ELTIF. We would suggest clarifying that the presentation format may be extended by adding tailor-made columns in case it is intended to issue multiple share/unit classes having different features in an ELTIF.

Q7 Given that the RTS enter into force after the date of application of the ELTIF Regulation and authorisations have been granted between the date of application of the ELTIF Regulation and the date of application of the proposed RTS, do you see a need for specific transitional/grandfathering provisions for the proposed RTS?

Yes. Taking into consideration that ELTIF is a voluntary product which needs to be seen as attractive to industry participants, we believe it would make sense to leave sufficient time for market players to implement the rules.

Q8 Do you agree with the above-mentioned reasoning in relation to the possible costs and benefits of the option taken by ESMA as regards common definitions, calculation methodologies and presentation formats of costs of ELTIFs? Which other types of costs or benefits would you consider in this context?

N/A.

Contact

Thank you in advance for taking our comments into account as part of the consultation 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.

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