European Private Equity & Venture Capital Association

EVCA, The European Private Equity and Venture Capital Association, comments on CESR's 2nd Consultation Paper on CESR's Draft Advice of Definitions concerning Eligible Assets for Investments of UCITS (CESR/05-490b)

21 November 2005

Introduction

EVCA represents the European private equity and venture capital industry. The association has well over 900 members, including the leading fund managers, and supports a wide range of initiatives designed to encourage an entrepreneurial environment in Europe, and establish high standards of business conduct and professional competence.[1]

EVCA welcomes the 2nd consultation opened by CESR on its draft advice of definitions concerning eligible assets for investments of UCITS (CESR/05-490b), further to its first consultation paper of March 2005 (CESR/05-064b).

This second consultation paper will help CESR to define whether and to what extent some financial instruments could be considered eligible investments. Clarification closely relates to the conduct of business rules within the current framework of the UCITS Directive, which has been designed for retail products, and the need to achieve rapidly a level playing field between Member states.

As the representative of the EU private equity and venture capital industry, EVCA will take the opportunity of this second consultation to confirm its first position dated June 2005[2].

[1] Private equity and venture capital supports the development of businesses by providing financing and assistance in their management and growth. Last year alone, over 8,000 European businesses benefited from private equity and venture capital funding, creating many thousands of jobs across all industry sectors and all sizes of companies in both new and existing companies. Many of the companies financed stimulate the research, development and innovation, essential to sustainable economic growth. In 2004, the private equity industry raised €27.4 billion from institutional investors and invested €36.9 billion in Europe's growth companies.

[2] For more information, please contact info@evca.com

Out of the seven areas covered in the consultation, EVCA will therefore answer to:

- Transferability criteria and closed end funds as transferable securities (Boxes 1, 2, 3);

- Techniques and instruments (Box 10);

- The level of supervision and unit holders protection of private equity and venture capital funds, as "other UCITS" (Box 12)

To fully assess the position of the private equity and venture capital industry, EVCA provides in annex a summary of the industry's business model, to facilitate a better understanding of the specificities of the asset class and its value within the framework of well-balanced harmonised UCITS, within the limits of investors protection and efficient portfolio management.

I. Clarification of Art. 1 (8) – Definition of Transferable Securities

1. Treatment of "structured financial instruments" (Box 1 - Q1)

Private Equity ("PE") and Venture Capital ("VC") securities are not generally admitted to trading on a regulated market and are not raised from the public but from proprietary channels. As such, the private equity and venture capital industry is not concerned by this question 1, referring to eligible assets under Art. 19 (1) (a).

2. Other eligible transferable securities (Box 2 – Q2)

Private equity and venture capital securities as such are part of the 10% share of any UCITS portfolio which is open to any securities that do not meet the eligibility requirements of Art. 19 (1) of the UCITS Directive.

Transferability

In respect of the consultation paper, regarding Box 2, private equity and venture capital funds shares comply with Level 2 and Level 3 requirements, except for the 4th indent of the first criteria of Level 2: securities are not freely negotiable on the capital markets. As mentioned in EVCA's response to the first consultation paper, those securities are not "transferable to a third party without a specific consent of any other party to the transaction". Investors in private equity and venture capital funds are linked together by a pre-negotiated contractual agreement which creates specific relationships between fund managers and fund investors ("Partnership Agreement"), which prevent the free transferability of their securities.

This limited transferability is one of the key elements of the private equity and venture capital business model to guarantee consistency in its investment strategy in order to fulfil the long-term needs of underlying investee companies.

Liquidity

Private equity and venture capital is essentially an illiquid asset class, investing in unregistered securities, as investors commitments are usually made to a fund over a period of time of 10 years. Private equity and venture capital funds offer little opportunity for investors to exit their investment early (i.e. in advance of the full close of the full term) without discounting the price.

However, investors in private equity and venture capital funds have to abide to specific requirements as to their eligibility in those funds. Such investors (professional individuals or institutional investors) are fully aware of the liquidity risk profile of their investment whose limitation is clearly stated in the Investment Memorandum (which they can negotiate).

In any case, the limited transferability and liquidity characteristics of private equity and venture capital funds securities do not expose investors to losses beyond their commitment. Moreover, the valuation of securities is available on a periodic basis and regular and accurate info is available to the investors. To that extent, their protection is safeguarded.

Regarding Level 3 (5)[3], the potential risk of insufficient liquidity in a harmonised UCITS portfolio investing in securities according to Art. 19 (2) (a) eligibility criteria is covered by the portfolio limit of 10% for those Art. 19 (2) (a) holdings. The remaining 90% of harmonised UCITS invested in Art. 19 (1) (a) holdings more than cover the requirements of Art. 37 of the UCITS Directive.

3. Closed end funds as "transferable securities" (Box 3 – Q 3)

EVCA is of the opinion that, after taking account of the limited transferability and liquidity of private equity and venture capital funds shares, those shares however can be regarded as eligible holdings for harmonised UCITS because:.

- The European private equity and venture capital industry is currently working with self-regulations[4], including corporate governance guidelines endorsed by the all industry participants and by national authorities for the purpose of investors' protection.

- The pre-negotiated relationship between investors (Limited Partners – "LPs") and the private equity and venture capital fund managers (General Partners – "GPs") is the guarantee of an "appropriate investors protection safeguards".

- In almost all EU-25 Member states private equity and venture capital managers are required to submit any private equity and venture capital fund structure and management company to authorisation granted by national supervisor or regulator

EVCA fully supports CESR's view that these investor protection requirements allow for UCITS to invest in private equity and venture capital closed end funds, under the limitation of Art. 19 (2) (a). All closed end funds should be treated equally where they meet Box 1 or Box 2 requirements and in addition the requirements of Box 3. However, this does not preclude any of the differences in business models between real estate funds, private equity and venture capital

[3] See page 13, CESR Consultation (assessment of liquidity)
[4] EVCA has issued pan-European guidelines for the reporting and valuation of private equity portfolios, corporate governance guidelines and a code of conduct which all EVCA members should follow. See: http://www.evca.com/html/PE_industry/IS.asp

funds and hedge funds, and potential Level 3 measures (as not mentioned here) should not mix those three assets into a "one size fits all" policy.

In case of listed closed end funds, EVCA does not see additional need for investors protection safeguards beyond those applied to other listed companies.

II. Clarification of Art. 1 (9) – Definition of Money Market Instruments

Private equity and venture capital funds are not money market instruments and, as such, are not concerned by this question as a potential eligible asset.

III. Clarification of scope of Art. 1 (8) (Definition of transferable Securities) and "Techniques and Instruments" referred to in Art. 21 (Box 10 – Q 10)

EVCA is supportive of CESR's position with regard to "identifying the criteria to be used to assess the compatibility of a given technique or instrument, rather than providing an exhaustive list and specifying under what circumstances each technique or instrument can fall under the scope of Art. 21 (2)". It is for asset managers to decide how far they wish to proceed and maintain this position once it has been approved by the regulators and the investors.

These criteria shall be assessed under the "purpose of efficient portfolio management", and regulatory approaches should be sufficiently flexible to understand these intentions and the use of efficient portfolio management by fund managers.

Level 2: To that extent, EVCA affirms that private equity and venture capital investments are for the purpose of efficient portfolio management. This means that the final objective of any investment is to generate additional capital or income for any UCITS investing in private equity and venture capital funds, with an appropriate and pre-negotiated level of risk and within the aforementioned limit of up to 10% of the UCITS portfolio in Art. 19 (2) (a) holdings. EVCA sees no reason to further restrict such investments in the absence of any market failure.

Level 3: Financial derivatives instruments are not managed by private equity and venture capital funds. In respect of point 5, as mentioned earlier, private equity and venture capital funds investment objectives are clearly stated in the Partnership agreement between investors and managers, so that general risk policy is well described and regular information and holdings valuations are regularly provided to investors, according to industry-wide endorsed reporting and valuation guidelines.

IV. Embedded derivatives

Private equity and venture capital funds are not embedded derivatives and, as such, are not concerned by this question as potential eligible asset.

V. Other collective investment undertakings (Box12 – Q 12)

Private equity and venture capital structures are part of "other collective investment undertakings". EVCA welcomes the revised arrangement in the second consultation document of the factors with regard to supervision and the protection of unit holders.

In the global framework of eligible assets for harmonised UCITS, including private equity and venture capital securities under Art. 19 (2) (a), the European private equity and venture capital industry supports the necessary supervision and protection of unit holders as outlined. This assessment shall be done with full knowledge of "Other collective investment undertakings" business model specificities. As mentioned (§110), "there is a need for flexibility" in pondering adequate factors.

EVCA is of the opinion that, as is currently the case throughout Europe, the private equity and venture capital industry "is subject to a supervision equivalent to the one laid down in Community law and as such (its securities are) generally eligible".

The Level 3 proposed guidelines leave enough flexibility to regulators in evaluating documentation submitted by "Other collective investment undertakings". This flexibility is supported and framed by indicators of equivalence as listed in Box 12 and should prevent any distortion of a level playing field between Member States. This flexibility will also protect new generation products.

Moreover, these requirements are in line with the actual management rules of the European private equity and venture capital industry and common industry standards[5]:

- *Supervision:*

o A Memorandum of Understanding (MOU) is signed directly between investors and managers. This MOU designs the framework of the funds functioning. It states, firstly, the necessary management and responsibility conditions for the management company and the depositary (including management fees). It also describes functions and controlling power of investment and consultative committees, organises co-investment rules when needed, and reporting rules to units' holders. Secondly, it describes the legal management of the units: issue and subscription of shares, capital calls, distribution, shares redeem and liquidity constraints. Finally, it describes how conflicts of interest, if any, should be resolved.

o All aspects of such an MOU are subject to supervision and authorisation by regulatory national bodies, including rules of the management company and choice of the depositary.

- *Protection of unit holders:*

o Autonomy of the management company: investing in the exclusive interest of the unit holders is granted by the MOU.

o Practical management rules such as the availability of information and reporting requirements, the existence of an independent custodian and reporting requirements are all included in the MOU, under the scrutiny of the national regulator.

o The general guidance of "the prudent man approach" is well respected through professional industry guidelines (see Box 3, close end funds as transferable securities, and European private equity and venture capital industry guidelines).

[5] See: http://www.evca.com/html/PE_industry/IS.asp

VI. Financial derivatives instruments

Private equity and venture capital funds are not financial derivatives instruments and, as such, are not concerned by this question as potential eligible assets.

VII. Index replicating UCITS

Private equity and venture capital funds are not index replicating UCITS and, as such, are not concerned by this question as a potential eligible asset.

Conclusion

According to the clarification points covered by this second consultation, private equity and venture capital funds securities may be regarded as eligible assets, meeting criteria of investors' protection and portfolio management in order to generate additional capital or income for harmonised UCITS, with an appropriate level of risk management. The share of private equity and venture capital assets, as part of a necessary diversification in a well-balanced harmonised UCITS portfolio, is properly limited to the current safeguards of Art. 19 (2) (a). The regime applicable to private equity and venture capital under the current regulations protects its non-retail orientation and, to that extent, shall not be included in the co-ordinated UCITS type.

Furthermore, EVCA welcomes the results of the recent CESR open hearing of 7 November 2005, and the numerous remarks from both regulators and market participants, indicating that the onus should be on asset managers (either of the UCITS or of the management company of other collective investment undertakings) to take responsibility for the investment risk analysis and in discussing it with regulators. The cornerstone of this approach are the factors for the investment manager to take into account when making investment decisions.

This will avoid any risk of the regulations becoming too prescriptive and impeding European financial innovation and thus returns in the long run.

EVCA remains at the disposal of the CESR and other stakeholders for further discussions on the issues noted above, and can be contacted via the address below:

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Annex:

Summary of the private equity and venture capital business model

1. It is important to define crucial criteria according to:

a) The type and intensity of the relationship between the investors and the managers;
b) How value is added through the holding of portfolio companies;
c) An analysis of the 'risks' (investment profiles) usually associated private equity and venture capital.

A. Investors - Managers

- The quality and number of investors are major criteria for private equity and venture capital. Investors are mostly sophisticated, and their number is limited. Sophistication depends on size of the commitments, experience, risk acceptance...: an investors' entry process is based on direct contractual negotiation and agreement between investors and managers (such as the Limited Partnership Agreement, the Règlement du FCPR…);

- Investment policy is pre-agreed in private equity and venture capital memorandum, whereas investments are unrestricted in Hedge Funds;

- There is little retail distribution for private equity and venture capital funds. In case of retail distribution, European retail private equity and venture capital funds are strictly regulated (with different levels of regulation according to the quality of investors and the distribution channels used);

- Investors' commitments are long term, with almost no exit possibilities before the legal end of the fund (usually 10 years);

- Just in time draw-downs in private equity and venture capital management. Cash management for investors is different and not "penalizing" for private equity and venture capital investors;

- -Private equity and venture capital profit sharing, "carried interest", is distributed at the legal end of the fund's life, after capital redemption, 'hurdle' and the effective exit from the underlying investee companies.

B. Value added process

- Private equity and venture capital investments are the outcome of long negotiations with individual entrepreneurs in non-listed securities;

- Private equity and venture capital investors are not passive investors: they provide capital increases and management input to ensure entrepreneurial value creation and participate in following financing rounds when needed. private equity and venture capital set a strategic agenda in the portfolio companies;

- Private equity and venture capital commitments of capital in investee companies are long term (5-6 years on average);

- In the due diligence processes PE/VC funds have a long-term entrepreneur's view to create value

C. Risk analysis

- Private equity and venture capital has no domino effect on markets: no derivatives, no indexes, no short selling, few if any listed shares (without even mentioning lock-up period constraints). Private equity and venture capital does not have the capacity or potential to massively disrupt or "shatter" stock markets;

- Private equity and venture capital has no negative "multiplier" effect: borrowing money for European private equity and venture capital funds is either forbidden or strictly limited to a small percentage of available funds.

- Private equity and venture capital valuation of the portfolio is made through annual / semi annual audited valuation, under the responsibility of auditors. This procedure allows regular assessment of the level of risk and no gross overstatement of performance;

- Investment principles and national regulations limit the private equity and venture capital management scope of action to guarantee a pre-approved risk diversification for the investors;

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