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LONG TERM INVESTORS

Brussels, 28 July 2019

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

Response to the ESMA consultation *on undue short-term pressure from the financial sector on corporations*

Introductory remarks

The Public Affairs Executive ('PAE') of Invest Europe appreciates the opportunity to respond to the consultation on undue short-term pressure from the financial sector on corporations.

Invest Europe is the Brussels-based association representing the European private equity, venture capital and infrastructure sectors, as well as their investors. Private equity and venture capital firms 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 / venture capital manager can bring.

Funds managed by private equity / venture capital firms hold investments for an average of six years, giving fund managers the time to help build successful and 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. It is this combination of patient capital and active ownership that characterizes the private equity and venture capital (business) model.

Every year private equity and venture capital managers invest over 80bn EUR into 7,800 companies, a large majority - 86% in 2018 – of which are SMEs. With the support of private equity and venture capital managers these businesses are more innovative, productive and resilient than their peers with other types of owners, which contributes to higher growth and job creation.

In our response, we provide some high-level reflections. As an association we are however not in a position to answer all the specific questions raised, as most of them are addressed to individual firms. That said, we do consider it important to share our thoughts from a broader private equity and venture capital perspective.

We hope that our contribution, which focusses on the role private equity and venture capital plays in providing long-term capital, will feed into ESMA's broader examination of short-termism in financial markets. We remain of course at your disposal for any further information you may need and would be happy to discuss this in more detail.

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Disclosures on ESG factors and their contribution to long-term investment strategies (Section III of the consultation)

Private equity and venture capital firms have a specific business model aimed at helping businesses grow to the next stage of their development. It involves identifying and managing key opportunities and risks in their investee companies, including those related to Environment, Social and Governance (ESG) factors. Why and how fund managers consider and implement material ESG factors will depend on circumstances specific to the investment. Which ESG factors have been considered, and how, will vary, reflecting the specificities of the company and its circumstances (e.g. nature of business, sector, geography, size, investment model, legal structure, jurisdiction, etc.).

Indeed, Invest Europe believes it is critical to ensure that any sustainability-related framework is workable for *all* affected parties, irrespective of the size and internal organisation of either the private equity and venture capital firms themselves or the companies and other assets into which they are investing. The nature, scope and complexity of the activities, and the level of experience in dealing with sustainability factors all need to be considered. Similarly, it is essential to consider the individual and cumulative effects of new rules (whether legislative or not), which need to be thought through carefully to ensure they are fit for purpose, practical and manageable within a private equity and venture capital context. We strongly believe that the evolution of a genuinely integrated and sustainable approach to ESG must be based on fostering the right mind-set, rather than taking a more prescriptive approach that could result in the development of a “box-ticking” culture.

Some fund managers are more mature and advanced in their ESG approaches in relation to investment decision-making than others in terms of disclosure to investors and how they apply ESG-thinking when working with the management teams of the companies in which they invest. This is often – though not exclusively – linked to the size of the fund manager and the resources they have available to them. It is important that regulators recognise the variability in fund managers size and capacity when developing new or revising existing financial services legislation to take account of sustainability.

Invest Europe strongly supports finding a balanced position, reflecting the importance of proportionality, flexibility and materiality, and recognizing the diversity across – and within - asset classes with different business models. A uniform (overly prescriptive) solution, disregarding the breadth and variety of investment strategies, practitioners, perspectives and current market practices, can and will never be appropriate.

The role of fair value in better investment decision-making (Section IV of the consultation)

Section IV of the survey enquires about the role of fair value in better decision-making and the impact of IFRS 9 on long-term investing. The main difficulty with IFRS 9 for investments in private equity and venture capital funds relates to the concept of fair value. The value at which an asset, e.g. a share, can be exchanged between knowledgeable and willing parties in an arm’s length transaction on open and liquid financial markets is the definition of fair value and is readily identifiable for listed equity investments.

This differs for private equity and venture capital, where the interim Net Asset Value (NAV) gives an indication of the progress of the underlying companies between the time the investment is made by the fund and the value actually received by the fund when it realizes its investment in the company.

Only at the point the investment is realized is the true value of the unlisted equity investment known. A change in the unrealized gains and losses in private equity and venture capital investing, as expressed by changes in the interim NAV of a private equity or venture capital fund, is not the same as a change in the listed price of a share: a change in an interim NAV could for instance simply reflect an injection of new capital to acquire new plant or machinery.

We note that the recycling of amounts from Other Comprehensive Income (OCI) to profit or loss for equity investments is not permitted, although transfers within equity reserves are allowed. While we understand the concern that some investors could use recycling as an earnings management tool, we would like to point out that in the case of unlisted equity investing through private equity / venture capital funds this is not a cause for concern because the interim NAV of the fund is determined independently of the investor(s) in the fund, as is the timing and quantum of any change in interim NAV.

Importantly, the timing of the realization of the underlying investment, and determination of the sale price is also completely independent of the investor. If an investor were required on the day it subscribed to a fund to make a one-off election as to whether it wished to recognize unrealized gains and losses in OCI, then recycle to the P&L, or wished to recognize unrealized gains and losses in the P&L straight away, this would not enable the investor to use recycling as an earnings management tool. Thus enabling investors to make such a choice for investments in unlisted private equity / venture capital funds could be a sensible step.

Institutional investors' engagement
(Section V of the consultation)

As part of the questionnaire, ESMA is also inviting market players to share their views on how to maximise the engagement of institutional investors.

While ESMA focuses on the impact of the Shareholders Rights Directive, we note that little attention is paid in the questionnaire to the role capital requirements play in determining how much capital institutional investors commit to long-term assets, including when these investments are made through funds. Risk weights are a crucial element to shape investors' asset allocation into long-term investments and this is an element that should be taken into account.

The recent revision of the Solvency II Delegated Acts to modify the capital charge for insurers' commitments is a step in the right direction. European Supervisory Authorities, in particular EIOPA but ESMA as well, have a key role to play in ensuring the principles set out in Article 171a of Solvency II Delegated Regulation are correctly interpreted and implemented across Member States. It is particularly important for supervisory authorities to apply the criteria provided in this Article at the level of the fund for insurers' investments in closed-ended and unleveraged funds. This is key to incentivising investors to allocate more capital to long-term projects.

Remuneration of fund managers and corporate executives
(Section VI of the consultation)

Another issue covered by the questionnaire is remuneration and its impact on the long-term vision of the firm. Private equity / venture capital is very specific in that regard, as it has put in place mechanisms to ensure that the interests of fund managers are aligned with the long-term interest of their investors.

In a typical private equity / venture capital model, the manager who is managing the fund on behalf of its investors, will first receive a "management fee" (typically up to 2% of the fund's committed capital p.a.), which is intended to cover the overheads of the general partner and fund manager, including salaries, office rents, etc. Given the length of the investors' commitment to the fund (the average fund lasts ten years, without redemption rights), other arrangements are put in place to ensure the fund manager is incentivised to focus on the long-term performance of the fund as a whole. This model is known as "carried interest".

Carried interest is an intrinsic feature of private equity and venture capital funds and essentially enables managers to participate in a share of the profits of the fund as a whole. As a share of the profits, carried interest distributions are only generated after investments are realised (i.e. cash returns have been achieved) and provided any preferred return on those investments agreed with the investor at the outset (typically 8% per annum) has been achieved. In most of the cases, the fund generally does not begin to accrue carried interest until several years into its ten-year life (as it is unlikely the fund will have any realizations and thus profits in the early years of its life).

Given it incentivises fund managers to make the fund a success until the very end of its long life, the carried interest model (as typically structured in private equity and venture capital funds and which is different to that perhaps encountered in other alternative asset classes) is one that should be well understood and protected by policymakers. We would thus like to reiterate that the fund manager - in line with the remuneration model described above - is rewarded in a manner that ensures their interests are aligned with those of investors into the fund throughout its life. Accordingly, we do not believe that there are common practices in the remuneration of private equity or venture capital fund managers that contribute to short-termism.

It is especially important to make a clear distinction between this model and performance fees in the different disclosure documents that have to be prepared by fund managers when marketing to certain categories of clients/investors. Overall, ESMA should be mindful that there is a wide range of remuneration strategies and structures adopted by alternative investment fund managers and it should therefore be careful to apply remuneration rules in a manner that reflects the nature and specificities of the different remuneration models.

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 document.

For further information, please contact Simon Tosserams (simon.tosserams@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 23 employees in Brussels, Belgium.

For more information please visit www.investeurope.eu.