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

Response to Consultations on the Investment Firms Directive and Regulation Technical Standards

1. Consultation Paper on draft RTS prudential requirements for investment firms

Question 1. Is the proposed articulation of the K-factors calculation methods, in particular between AUM and CMH and ASA, exhaustive or should any other element be considered?

We appreciate that ancillary services such as advice on transactions between investors, should not be included in the measuring of the AUM, nor in that of the COH, given K-factors already account for them. In general, we support the attention the EBA has taken, in light of the objectives of the Regulation, to avoid double-counting assets.

While AUM does not have to be counted twice when it is the subject of a delegation by a "financial entity", this term itself is not defined. We consider the EBA position - that it is confined only to EU entities such as AIFMs, UCITS management companies and MiFID entities - is too narrow. Our view is that this should be extended to any financial firm, irrespective of their location, to take into account cross-border situations.

For example, it is illogical to exclude from this concept entities just because they are not European or they are subject to a different (but still substantial and respected) scheme of regulation. The underlying clients of the non-European entity will not benefit from the increased capital requirement of the European firm to which portfolio management activities are delegated and it is likely to increase the cost of doing business with European firms which is not balanced by a commensurate benefit.

Moreover, it appears from the draft text that, when a portfolio manager appoints another investment firm to provide it with investment advice of an ongoing nature to assist it with its portfolio management functions, this should not be seen as a delegation.

The result of this is that the adviser will therefore need to include the assets in its own K-AUM. This would create a situation where there these are effectively double-counted, which is what the delegation provision was intended to avoid.

More specifically, the EBA language as drafted is not sufficiently tailored to reflect the way in which firms operate and for drawing a distinction between a delegation and the appointment of a sub-adviser. For example, it is common for portfolio managers to have some teams which locate investments and advise on them and teams which monitor those investments on an ongoing basis and provide advice on them. In each case, the advice will be given typically to the internal committee which takes the final decision. The service of portfolio management therefore does not take place in a single step. Separate steps can - and often do – include activities which would fall within the definition of advice of an ongoing nature. We believe that it should be permissible for part of the service to be delegated, even where each part is not separately identified in the appointment of the portfolio manager. These clarifications are required if the EBA seeks to avoid double-counting in those cases, especially as those examples effectively meet the purpose of the delegation provision.

Even if the EBA, counter to what could logically be expected given how the market operates, disagrees that there could be a partial delegation where the element to be delegated is not separately identified in the contract, the wording of the standards is still too broad. The form of appointment may list a number of services which are included in the overall provision of portfolio management and the manager could delegate part of the service it has been contracted to provide. Where part of that service relates to investment advice of an ongoing nature, the Regulation states that the entity to which that part has been delegated should not have to calculate AUM in respect of it. The proposed wording of the RTS would restrict this unnecessarily.

Question 6. Do you have any comment on the elements included in this Consultation Paper for the application of the aggregation method?

The extension of the concept of "significant influence" beyond the general interpretation in Directive 2013/34/EU (20% or more voting rights) may reveal itself problematic and not reflect the nature of the relationship between certain investment firms and the companies they are linked to.

These terms are already used in a number of EU legislations and are well understood. The EBA's proposed language will create tensions between different sets of rules and/or produce anomalous results, under which a firm needs to take one approach for the purposes of this Regulation and a different one under other regimes.

Perhaps most problematically, a number of the examples given in the standards would not necessarily mean that a firm is under "significant influence" of another firm as it is now understood, or that it is "managed on a unified basis" by another (and, indeed, protections may exist in governance arrangements or contractual documentation or other arrangements which would factually preclude such conclusions).

In relation to the "significant influence" concept in particular, the EBA's proposed elaboration appears to be inconsistent with the current CRD IV/CRR regime where this is a matter reserved for the national competent authority to address whether consolidation (on the basis of significant influence) is required in light of a specific set of facts. While this may change under the CRD V/CRR II regime for banks and certain large systemic investment firms, we suggest that the current CRD IV/CRR approach is more proportionate for firms within the scope of IFR/IFD, especially given their size and their heterogeneity.

2. ***Consultation Paper on draft RTS on criteria to identify categories of staff whose professional activities have a material impact on an investment firm's risk profile or assets it manages under Directive (IFD) 2019/2034 of the European Parliament and of the Council on the prudential supervision of investment firms***

Question 3: What would be the appropriate percentage of own funds to determine that a business unit has a material impact on the risk profile of the investment firm? It would be most helpful if respondents could provide a quantitative estimation of the number of staff identified under this criterion at the indicated percentages in addition to the other qualitative criteria within the draft RTS as well as the cost for the application of that criterion.

We would not be in favour of introducing such a test for MiFID entities at all. The other qualitative criteria in the draft Article are sufficient to cover all relevant staff members. The additional paragraph would cause private equity firms to carry an extra test, adding unnecessary complexity without catching significant numbers of additional staff.

Firstly, many private equity firms are comparatively small firms by number of staff. These firms will often operate a single business unit or, where they may operate multiple business units, the heads of those units will invariably already be caught by one of the other qualitative or quantitative criteria, for example as members of the management body.

Secondly, larger private equity firms may only operate a single business unit (this may be the case, for example, for firms running only private equity, rather than more diversified, strategies). Where they may operate multiple business units, management structures are typically relatively flat, hence the heads of business units generally be caught by the criteria of members of the management body or senior management, which are designed to bring within scope the top two layers of management within any firm.

The proposed Article 5(7) seems sufficient to cover relevant parties, especially as material risks referred to in Article 28 of Directive (EU) 2019/2034 includes risks that affect the firm in relation to all its activities (and not just the regulated activity of managing investments).

Question 4. Are the qualitative criteria within Article 5 appropriate and sufficiently clear?"

We do not consider the criterion at draft Article 5(8) either appropriate or sufficiently clear for the following reasons:

(i) whilst it seems to be designed to capture the heads of certain functions of a systems nature (execution or approval of processes or systems etc), it is not entirely apparent from the drafting whether these must in each case relate to one or more of (a)-(d), or whether it is only providing IT or security which must relate to one or more of (a)-(d). We assume the former, but if the criterion were to be retained in some form, this should be clarified;

(ii) we also assume that the reference to "providing IT or security" is intended to refer to "providing IT or <u>information</u> security". Again, if retained, this should be confirmed; and

(iii) the reference to "the execution or the approval of processes or systems" is vague and potentially wide in scope

Each criterion is intended to bring within scope individuals whose professional activities have <u>a material impact on the risk profile of the firm or of the assets it manages</u>. In our view, the current draft does not achieve that. For example, it is not apparent how heading a function responsible for economic analysis in relation to nondiscretionary advisory arrangements of an ongoing nature could have a material impact on the risk profile of the firm or of those assets. Economic analysis is by its nature an assessment rather than a decision, and arguably it is only the implementing decision which is in any sense capable of having a material impact on any risk profile.

Importantly, and as explained in the response to Q3, anyone in a position to take decisions which could have such a material impact is likely already to be caught by one of the other qualitative criteria, or the quantitative criteria, especially in private equity firms with few business units and many of which are often comparatively small firms by number of staff.

3. *Consultation Paper on draft RTS on classes of instruments that adequately reflect the credit quality of the investment firm as a going concern and possible alternative arrangements that are appropriate to be used for the purposes of variable remuneration*

Question 3: Are the provisions in Article 6 appropriate and sufficiently clear? Where respondents are of the view that the draft RTS should define a set of specific arrangements rather than providing conditions that such arrangements should meet, comments are most helpful, when they clearly describe the alternative arrangements that investment firms desire to use to ensure that variable remuneration is aligned with the long-term interest of the investment firm and its risk profile.

Context: *Alternative arrangements that may be used by investment firms for the pay out of variable remuneration under point (k) of Article 32(1) of Directive shall comply with the condition, among others that the alternative arrangement* ***allows the application of deferral and retention of the amounts of variable remuneration received***.

Contrary to what the EBA has indicated in its slides, we are not convinced that the current conditions for alternative arrangements are sufficiently flexible, in particular for investment firms using specific remuneration arrangements fulfilling the same objectives as pay-out in shares or other prescribed instruments, such as carried interest.

We welcome the principles underlying the provisions in the draft Article 6, in particular that alternative arrangements should contribute to the alignment of variable remuneration with the risk profile of the firm and that they should allow the application of deferral and retention of the amounts of variable remuneration received. Our concern is that whilst carried interest arrangements in particular are invariably designed to, and do in practice, reflect those principles, the number and prescriptiveness of the provisions in the draft Article 6 could defeat their underlying object.

For this reason, we support a shorter, more principles-based, set of criteria. This is especially true as it is likely there will be a political willingness to align remuneration standards for investment firms and other types of financial entities, including asset managers, for which such arrangements are more common, putting them at risk and reducing their effectiveness in aligning long-term interest of the client and the firm.

As a reminder, carried interest arrangements exist in order to align variable remuneration of staff with the performance of the assets they manage or advise on. The intention is that if those assets perform poorly, and, broadly speaking, if the firm therefore performs poorly, variable remuneration should be reduced. They also have in-built deferral and retention mechanisms. While carried interest arrangements are agreed at the outset of the fund, cash is typically <u>only paid</u> by the fund to the carried interest participants once investors have had their drawn capital back plus an agreed preferred return. The period between the agreement of the carried interest arrangement and cash being paid out will typically materially exceed the minimum ‘deferral’ period of three years. There are however in that context mechanisms available (i.e. escrow and clawback) to ensure that if carried interest allocations are paid out early in the life of a fund (as might be the case if an early investment is realized for a very large return before all the capital has been drawn down from investors), then neither the manager nor its executives will have received any more than the agreed carried interest percentage on the profits of the fund by the end of the life of the fund.

We stand at the disposal of the EBA to give further information on the nature of the carried interest model and its specificities.

Contact

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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.

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