

RIS - Standardised Undue costs & Value for Money rules:

A risk for long term investments

Introduction

Undue costs and value for money rules have been heavily discussed in past negotiations on the Retail Investment Strategy, not so much for a lack of disagreement on their (laudable) objective but for how these rules would work in practice.

Without reinventing existing debates, and acknowledging that several Member States have already expressed some of the views detailed below, this short paper is aimed at giving the perspective of the private equity asset class on ongoing negotiations.

This is especially relevant because... while private equity only represents a specific sub-segment of capital markets, it is **the model most likely to be affected, would proposed rules be too standardised**.

Because of the long-term nature of their funds and their active investment model, **private equity funds are very different from the traditional retail-oriented funds** for which these rules were initially conceived. They are most likely to be affected by strict requirements. Reversely, introducing sufficiently sophisticated requirements would best account for asset class specificities.

In other words, how rules affect private equity funds is a good benchmark of how appropriate they can be...and how likely they are to disrupt markets negatively

This is also important as... many private equity sub-segments, not least venture capital and infrastructure, have **long been considered to play a crucial role in the financing of certain types of EU businesses**.

Would rules affect their distribution, this could have **massive consequences on start-ups, scale-ups and infrastructure companies**.

Who we are

Invest Europe represents private equity and venture capital managers as well as investors in their funds. Most private equity managers only market their funds, which are in most cases closed-ended, to **institutional and sophisticated investors**, such as pension funds, insurance companies, sovereign wealth funds, high net worth individuals and family offices.

Recently, more and more private equity managers have sought to develop products that can be sold, through intermediaries, to **smaller, retail investors**. While minimum investment commitments remain relatively high, new types of liquidity options are developed to allow new types of clients to access the asset class, in particular through recently revised ELTIF structures.

1. Undue costs rules

While they remain a good idea... as the core principle of undue costs rules is to prevent managers to charge fees to clients higher than was initially planned.

What can go wrong (for the funds we represent)

For long-term funds such as private equity, it is **not always easy to plan costs in advance**, or at least to determine their exact amount or even an estimate thereof.

Obviously, managers can determine before the fund is sold certain types of fees, such as the amount of **management fee** they will charge or the percentage at which they will set a **carried interest** mechanism (*a profit-sharing mechanism for the manager above a certain % of return for their investor*).

However, long-term fund managers will not be able to know **how expensive it will be to buy businesses** (transaction or “due diligence” costs being linked to specific transactions), meaning they will not be in a position to report these costs beforehand.

On top of this, as some of the **fees are calculated as % of the capital raised**, the fact that this capital may not be known at the time investments are made can make it difficult for managers to present costs in the way requested by the law.

What happens in real life with current rules

The reality of the private equity market is that costs that will be disclosed in the KID are not exact costs investors will face...but costs under the most extreme situations. In other words, private equity managers often pretend they have much higher costs than they really have just to ensure they are compliant with the law

What policymakers should take into consideration

Sufficient flexibility should be left to managers to acknowledge that there are situations where the manager is unable to give the investor an exact idea of what the cost will be (provided of course this fact is well disclosed).

If this is not done, the risk is that managers offering funds with specific fee structures will face severe obstacles when setting up their funds.

It should **remain possible for a fund manager to disclose to investors that some costs are not known at the time of investments**. This would avoid situations where managers are forced to disclose costs that will likely not be charged, a common situation under current rules.

What could be the impact of rules

The current approach to undue costs is one that considers that only viable fund structures are those that offer standard fees. These are typically the types of funds that offer least value to clients and to the overall economy...and that are most likely to be offered after RIS is passed.

Value for Money rules

A good idea: The concept behind value for money rules is to ensure that managers who offer products with low performance and high fees correct this or are prevented from being sold

Is this a workable concept?

As has already pointed out by many Member States, value for money should by definition be seen the ratio between returns and fees, i.e. performance net of fees (starting from the principle that the goal is not to benchmark costs against each other irrespective of performance).

Unfortunately, for long-term funds such as private equity, and *a fortiori* for any closed-ended funds which has not yet been invested at a time of marketing:

- Fees are not necessarily known at the time of marketing (see *above section*)
- Performance:
 - o will necessarily not be known for many years
 - o will depend on a series of factors, from the experience of the manager, to the sector of investment, to the vintage year, to the fund strategy...(in other words, performance is not comparable from fund to fund)

In that context, calculating AND comparing performance net of fees in a way that would be meaningful to the client **appears**, however relevant to the investor (and to the best managers who would benefit from being seen as the best), **highly unrealistic** for these types of structures.

What can go wrong (for the funds we represent)

Unfortunately, a lot could go wrong if, as was the case in the KID project, benchmarks would be developed for all fund structures.

Scenario 1: Would the EC proposals be interpreted very strictly by ESMA, this could simply mean the end of funds such as private equity - which could either:

- not be able to give regulators with the information they request
- not justify their generally higher performance (not known at the time of marketing) against their generally high fees.

Scenario 2: Would ESMA make small mistakes in its fund categorisation, this could lead to catastrophic situations where some structures are discouraged against other structures, despite good reasons for the difference between these structures.

One obvious example is the distinction between venture capital and buyout funds. ESMA could very easily be tempted to classify the two within the same bucket, without realising that, due to their typical size and investment sector, venture capital funds generally have slightly higher costs than buyout funds.

The task given to ESMA to create fund types would be extremely complex and that KID debates have shown this can lead to absurd situations for certain structures where the standardised rules apply indiscriminately to all types of structures.

Scenario 3: Even if ESMA is able to create an absolutely perfect system, it is doubtful such a system would create meaningful comparison for clients given the diversity of funds

Moreover, there is a risk that benchmarks would create a situation where costs would become standardised, which would be at the detriment of the quality of service to the clients.

The fundamental risk of standardisation of costs: the commercial case of private deals

While the terms of standardised mass-retail offers are by nature known from the public and advertised widely, this is not the case of all funds' offers. Some, in particular long-term funds, are the result of a private negotiation between the investor and the fund manager, where the commercial terms of the deal are confidential and should only be shared to the national competent authority.

Some of the RIS suggestions create a concern for these negotiated offers as they seek to create a industry-wide, public template. Would there not be some form of carve-out for these offers, there is a real risk of reducing market diversity and the ability of managers to offer specific fund structure to specific types of sophisticated clients, retail or not.

In order to avoid this, limiting disclosure to the NCA or ensuring the obligation only applies to mass-marketed offers would be important to avoid an unintended impact of the rules.

Conclusion

Undue costs and value for money rules serve an important purpose but the **extent of their potential negative impact on certain non-standardised fund structures** should not be underestimated by Member States, which may naturally focus on their impact on standardised products offered to investors.

It is therefore important that **rules are drafted in such a way that it avoids the many hurdles posed by current requirements**, including by introducing a series of clarifications on the costs that should effectively be included in the process and the situations where, under good reasons, such costs are either not known or performance is not well established.

Member States should only move forward on the proposed rules after having had conversations with **all sectors of their financial industry**.

Without a proper assessment of the impact on all sectors likely to be affected by the rules, the risk is very real that the proposal would affect the distribution of fund structures whose purpose is to offer certain types of clients, retail or not, products that fit their specific needs. This is particularly true of fund structures such as venture capital which are typically not marketed to retail investors directly but which may have a handful of sophisticated investors not able to get the professional investor status.

As EU businesses desperately need sufficient private financing, and in light of the risks outlined below, **calibrating the RIS proposals properly should be seen as a top priority to maintain EU competitiveness** in some sectors and **to protect recent CMU achievements, not least the ELTIF review** which was due to prop-up long-term investments.