AMERICAN INVESTMENT COUNCIL

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THE VOICE OF PRIVATE CAPITAL
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LONG TERM INVESTORS

SUBMITTED ELECTRONICALLY

***Via* email: fsb@bis.org**

September 21, 2016

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002, Basel
Switzerland

Re: FINANCIAL STABILITY BOARD, "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" (Jun. 22, 2016)

Ladies and Gentlemen:

These comments are submitted by the American Investment Council (the "AIC") and Invest Europe and represent the position of the private equity industry in the U.S. and Europe.

The AIC is an advocacy, communications and research organization established to advance access to capital, job creation, retirement security, innovation and economic growth by promoting long-term investment. In this effort, the AIC develops, analyzes and distributes information about the private equity and growth capital industry and its contributions to the U.S. and global economy. Established in 2007 and formerly known as the Private Equity Growth Capital Council ("PEGCC"), the AIC is based in Washington, D.C. The AIC's members are the world's leading private equity and growth capital firms united by their commitment to growing and strengthening the businesses in which they invest. For further information about the AIC and its members, please visit our website at http://www.investmentcouncil.org.

Invest Europe, formerly known as the European Private Equity & Venture Capital Association ("EVCA"), 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 investors including pension funds and insurers, to the benefit of the millions of European citizens who depend on them, as well as contributing to the broader economy and job creation.

The AIC and Invest Europe appreciate the opportunity to provide comments to the Financial Stability Board ("FSB") on the consultative document, "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" (the "Consultative Document").[1] The AIC and Invest Europe are grateful that the Consultative Document appropriately reflects our view that private equity firms and funds do not present systemic risk. This view has been set out in detail in a number of prior submissions to the FSB as well as to U.S. and European authorities (these prior submissions are listed in the appendix).

Below we outline why private equity firms and funds do not give rise to the policy concerns regarding asset management activities generally that the FSB expresses in the Consultative Document.

Private Equity Firms and Funds Do Not Give Rise to the FSB's Policy Concerns

The AIC and Invest Europe have expanded on the points below in extensive detail in our prior comment letters and we encourage the FSB to refer to those prior submissions for a more detailed explanation of the reasons why private equity firms and funds do not raise financial stability concerns.

1. No liquidity mismatch: lack of any general redemption rights.

The Consultative Document says that a key structural vulnerability from asset management activities is the potential mismatch in open-ended funds between liquidity of fund investments and the ability to redeem fund units.[2] Private equity funds do not give rise to this concern because they typically are structured as closed-end vehicles where investors do not have redemption or withdrawal rights that would enable those investors to force a fire sale of assets by making a "run on the bank." Indeed, redemption during the life of the fund typically is prohibited by the legal agreement which governs the fund. For this reason, the structure of private equity funds avoids the potential for fire sales that in turn could drive down investment values and adversely affect other members of the financial system.

2. Leverage: limited use of leverage by private equity firms and funds.

The consultation paper identifies the use of leverage as a potentially important structural vulnerability in the asset management sector. It also states that the use of leverage can create and / or amplify risks to the global financial system through direct and indirect channels and posits that leveraged firms and funds can spread risks to the

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[1] FSB, "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" (Jun. 22, 2016), *available at* http://www.fsb.org/wp-content/uploads/FSB-Asset-Management-Consultative-Document.pdf [hereinafter FSB, Consultative Document].

[2] *Id.,* at 10.

global financial system through interconnections with investors and other financial intermediaries and businesses. As described below, private equity firms and funds do not give rise to this concern because, as a general matter, they are not leveraged and are not highly interconnected with other participants in the financial system.

i. Limited use of leverage

Private equity firms and funds generally are not leveraged at the level of the fund and are legally structured to prevent exposure for the fund itself beyond the capital committed by investors. They stand in contrast to banks or certain types of investment vehicles, which are (frequently highly) leveraged.

Private equity funds do sometimes engage in certain practices defined as "leverage" under particular regulations (for example, under the EU Alternative Investment Fund Managers Directive). Invariably, any such exposures are backed by contractual, binding, uncalled commitments from investors to contribute capital to the (closed-end) fund on an on-demand basis (as compared to being backed by the assets of the fund). The fund will therefore not exceed the ratio of 1:1 between exposures and committed capital. Typically, the fund constitutional documents will place an absolute restriction on the fund creating exposures beyond the total committed capital. However, such uncalled commitments are not typically reflected in the fund's net asset value ("NAV") under applicable accounting frameworks, so any test for leverage that is predicated on the relationship between exposures and NAV could misleadingly treat such practices as if they were leverage used to magnify exposures.

For example, a private equity fund generally is permitted to borrow only on a short-term basis for the very specific purpose of efficient cash flow management, i.e. to bridge the period from when an investment is made by the fund to when money is received from investors following the issue of a draw down notice on already committed capital. Amounts borrowed at the fund level for these purposes are typically capped and secured for their duration against the undrawn (but legally binding) commitments of investors and, therefore, do not increase the aggregate amount available for investments at the fund level. This arrangement does not result in any exposure to the private equity fund, as any such borrowing is completely matched by a legal commitment from investors.

To explain further, security for borrowing under such a bridge facility generally consists of the following components. First, an assignment (or pledge, as appropriate) to the lender of all rights of the fund under the applicable partnership agreement with respect to undrawn commitments (including the right to issue and deliver drawdown notices), exercisable by the lender upon an agreed enforcement trigger (e.g., an event of default under, or acceleration of, the finance documents). Second, a security interest over the bank account(s) of the fund into which investors' commitments are funded following the issue of an investor drawdown notice (enforceable by the lender upon an agreed enforcement trigger). In addition, more recently, some security packages provide (in lieu of an assessment of investor commitments) that the fund gives a power of attorney to the lender, appointing the lender as its attorney to exercise rights with respect to undrawn commitments upon an agreed enforcement trigger.

Further, portfolio companies, which frequently borrow, also do not present financial stability risks from their borrowing. More specifically, the failure of any particular portfolio company would not cause the failure of other portfolio companies in which the same fund invests, the fund itself or the private equity firm that sponsors the fund, because portfolio companies neither pledge their assets as security for, nor do they guarantee, each other's obligations.[3]

ii. FSB recommendations on leverage

We acknowledge the FSB's recommendation to develop a simple and consistent measure of leverage in funds (recommendation 10). We suggest that this new framework should not treat as leverage exposures of a closed-ended fund fully backed by uncalled commitments.

If, however, leverage were assessed by reference to NAV, then bridge financing that is fully secured by investor capital should not be included at all in the scope of such measures. Such financing, as used by private equity funds, is fundamentally different in its nature and its systemic risk implications as compared to other types of cash borrowing used by certain other asset managers.

Moreover, any regulatory reporting regarding the use of leverage that authorities develop (e.g., as contemplated by recommendation 11) should not be required of private equity firms and funds, given the limited use of leverage that we describe above. More specifically, investment funds with a simple structure and inherently low risk profile, which would cover a typical private equity fund, should be excluded from any such reporting mandate. We think this result would appropriately recognize that private equity firms and funds do not present systemic risks and are different in nature than highly-leveraged vehicles that use leverage to magnify exposures.

Moreover, if a new measure of leverage were to treat a private equity fund as being technically leveraged to some modest degree, then the private equity fund should not be subject to policy measures designed for a highly-leveraged fund that uses leverage

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[3] Although portfolio companies borrow, there is evidence that the average default rate for private equity portfolio companies is lower than the average default rate for non-portfolio company borrowers. *See* Steven Miller, *Romney, Private Equity and Defaults: What the Record Shows*, FORBES, Jan. 23, 2012, http://www.forbes.com/sites/janetnovack/2012/01/23/romney-private-equity-and-defaults-what-the-record-shows/ ("the average default rate of private-equity-backed loans between 1998 – the beginning of our data series – and 2011 is 3.97% versus 4.62% for non-sponsored deals").

to magnify exposure. For example, under the EU Alternative Investment Fund Managers Directive, the manager of a fund treated as leveraged (to any degree) must implement systems and controls to deal with liquidity risk at fund level, even though the fund is closed-end. The FSB should specifically avoid such a result, which we do not believe serves a policy purpose, in any final framework.

3. Operational risk: limited size and no critical functions.

The FSB notes that while operational risk in transferring assets and customer accounts during periods of market stress, "have been infrequent in the past and have not raised financial stability issues," these issues may materialize "if they affect an asset manager of sufficient scale or complexity."[4]

The AIC and Invest Europe concur with the FSB's opinion that the proposed recommendation to address the residual risks associated with operational risk and challenges in transferring investment mandates should only apply to asset managers that are large, complex and/or provide critical services – this would not include private equity firms or funds. The FSB, however, must ensure that the proposed approach does not have any unintended consequences with respect to funds that do not provide critical services or which are not complex or which are not sufficiently large. The FSB should also make clear that any criteria / indicators do not apply automatically to all asset managers regardless of size (i.e., the criteria / indicators should not apply to a manager or fund if its activities do not pose financial stability risks).

As explained earlier in this letter, private equity funds typically are closed-end vehicles and investors cannot withdraw their commitments from the fund at will, nor even on notice and there is therefore there is no risk of liquidity mismatch. Private equity firms and funds are not deeply interconnected with banks and other non-bank financial companies and are relatively small in size compared to large banks, insurance companies, broker-dealers and advisers to registered investment companies and do not provide the kinds of products, services or infrastructure that are necessary for the functioning of the global financial system.

For these reasons, private equity firms and funds do not give rise to the operational risk concern that is described in the FSB Consultative Document.

4. Securities lending: not relevant for private equity firms and funds.

Private equity firms and funds as a general matter do not provide indemnified securities lending services to their clients. Thus, this concern is not relevant for private equity firms and funds.

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[4] FSB, Consultative Document *supra* note 1, at 28.

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For the reasons outlined above, the AIC and Invest Europe believe that the activities of private equity firms and funds do not present risks to financial stability or otherwise give rise to the concerns expressed in the Consultative Document. Any new test for leverage, and any policy response to concerns about leverage in funds, should exclude private equity funds, because the exposures of such funds are fully covered by commitments from investors, as described above. We also strongly believe that private equity firms and funds are unlikely to raise other financial stability concerns. Our views on this broader topic are set out in more detail in the various submissions that we cite in the appendix.

The AIC and Invest Europe appreciate the opportunity to comment on the Consultative Document and would be pleased to answer any questions you might have regarding our comments, or regarding the private equity and growth capital industry more generally.

Respectfully submitted,

Jason Mulvihill
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American Investment Council

Michael Collins
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Appendix – Previous submissions

Below is a list of a number of the AIC's and Invest Europe's prior submissions to 2qzequity firms and funds do not present systemic risk concerns.

- PEGCC and EVCA Letter re: FSB Proposed Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, (May 29, 2015).

- PEGCC and EVCA Letter re: FSB Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (April 7, 2014)

- PEGCC Letter to the Financial Stability Oversight Council ("FSOC") (Mar. 25, 2015) (commenting on the Notice Seeking Comment on Asset Management Products and Activities – Docket No. FSOC-2014-001).

- PEGCC Letter to the FSOC (Dec. 16, 2011) (commenting on the Second Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies – Docket No. FSOC 2011-0001).

- PEGCC Letter to the Federal Reserve Board (March 30, 2011) (commenting on Proposed Rule for Definitions of "Predominantly Engaged in Financial Activities" and "Significant" Nonbank Financial Company and Bank Holding Company – Docket No. R-1405).

- PEGCC Letter to the FSOC (Feb. 25, 2011) (commenting on the Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies – Docket No. FSOC 2011-0001).

- PEGCC Letter to the FSOC (Nov. 5, 2010) (commenting on the Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies – Docket No. FSOC 2010-0001).