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AMERICAN INVESTMENT COUNCIL
Growth Through Long-Term Investment

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Public Comment on IOSCO Report: Leverage

I. Introductory comments

Invest Europe[1] and the American Investment Council ("AIC") appreciate the opportunity to provide comments on the International Organization of Securities Commissions' ("IOSCO's") consultant paper ("Paper") on behalf of the Financial Stability Board ("FSB") to determine coherent measures of leverage in the asset management industry.

We welcome IOSCO's goals to create metrics to measure leverage risk in investments funds. Further, we endorse IOSCO's methodology put forward in the Paper to approach the issue in two steps: first, eliminating those funds unlikely to pose risks to the financial system, and second, performing risk-based analysis on those funds that remain. Dividing the approach this way ensures no time is wasted looking at funds that should clearly be excluded. To that end, we believe closed-end funds without withdrawal rights, including private equity, should be excluded under the first step of this analysis because they do not deploy leverage in manners that create contagion and other risks. We also believe that many of the data points suggested in step 2 are not relevant in the private equity context.

Private equity funds have specific structures, business models and investment characteristics that differentiate them from other forms of asset management. Private equity funds are closed-ended, most often structured as limited partnerships. Institutional and sophisticated investors make contractual, binding commitments to the fund, which are drawn down when needed, to be invested in equity from companies, as applicable. The main aim of private equity funds is to help build sustainable businesses, which are eventually sold at a profit. The funds do this by making long-term – on average six years - equity investments in businesses and, in their capacity as shareholder, setting the governance framework for the business and so improving it.

Private equity funds are not typically leveraged and do not use leverage - as that term is normally used in financial markets - at the level of the fund. However, depending on the methods used to measure leverage, such as those proposed by the Paper, regulators may deem some activities carried out by the fund manager as leverage, despite posing no or very limited risk to the financial system, and, in particular, no risk of failure of the fund due to over exposure. For example, a fund that borrows backed by its uncalled committed capital would pose no material risk to the financial system because all borrowing can be quickly re-paid once the capital commitment is drawn from investors. However, net asset value ("NAV") does not capture

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[1] Invest Europe responds on behalf of the Public Affairs Executive (PAE) of the European private equity and venture capital industry. The 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).

this. This makes the IOSCO's proposed methodology particularly relevant from the perspective of our asset class.[2]

Given these unique aspects of private equity funds – which they share with other types of closed-ended funds, we call on IOSCO to include a paragraph in its final report addressing the particular circumstances of institutional closed-end funds, by calling for them to be excluded from regulators' consideration at step 1, especially if the exposures are fully backed by commitments (which, with NAV, we label "Adjusted NAV").

In addition, other asset classes such as credit funds that use closed-end fund vehicles, ought to be supported and facilitated, including by IOSCO, because they are not subject to unpredictable redemption requests and their use is a potential means to mitigate liquidity mismatch risk in other asset classes.

i. General approach of the Report

As representatives of the private equity fund industry, we are grateful that the approach taken by IOSCO respects the way fund managers are currently perceived in both the European Union and the United States and acknowledges the wide diversity of fund structures and the way they are exposed to counterparty risk. As the Paper lays out, for the systemic risk assessment to be meaningful, methods used should be able to capture the specifics of the asset management industry and be consistent with the methods currently set in the existing legislative frameworks.

We appreciate IOSCO has taken into consideration that imposing broad and general measures of leverage might capture activities that do not increase funds' exposure to third parties and do not pose any systemic risk. Any attempt to merge existing methods, or to build a cross-sectorial approach which would not recognise the specificities of the asset management industry as a whole, could have led to situations where some asset management firms would be deemed to pose systemic risk while they do not actually create any risk to the financial system.

Moreover, we agree with IOSCO that using a variety of methods to reflect the diversity of assessments may be the best way for legislators to determine whether or not a fund is leveraged. Nonetheless, the measures themselves must be chosen such that they identify, by reference to a fund's underlying assets and strategies, different types of activities related to leverage that genuinely pose systemic risk. Otherwise, they risk being meaningless.

ii. Step 1: Analysis of potential metrics and specificities of private equity funds and their relevance for IOSCO's approach.

We agree with IOSCO's assessment that there is a wide diversity of funds and that not all of them should be treated the same way. Over-simplified, "one size fits all" measures that treat activities with very different risk profiles in the same way can have unintended consequences particularly for specific business models such as private equity.

In the description of step 1 in the Paper, IOSCO outlines three potential metrics to measure a funds market exposure: the Gross Notional Exposure, without and with adjustments ("GNE" and "Adjusted GNE" respectively) and the Net Notional Exposure ("NNE"). We appreciate that IOSCO acknowledges that the GNE and Adjusted GNE metrics do not accurately capture a fund's market exposure, specifically because they do not take into account hedging. We further appreciate the acknowledgement by IOSCO that supplementary data points might be useful in evaluating which fund should be excluded during step 1 of the analysis. In terms of NNE, we believe NNE is helpful in separating market exposure versus hedging, but we also believe

[2] Further, the Paper seems to be largely focused on synthetic leverage (i.e. the use of derivatives). However, private equity funds rarely engage in this type of leverage except to hedge positions to protect against risk.

regulators should acknowledge its insufficiencies in completely accounting for hedging and should take the amount of uncalled commitments into account when looking specifically at closed-end funds, either in calculating the metrics themselves or as a supplementary data point. We would like to stress the following elements of direct relevance to our members considering their specificities, covering all aspects of the response.

a)The features of closed-end funds warrant special treatment

Because private equity funds invest in only a relatively small number of positions (i.e. the equity of typically private companies), for which opportunities arise only infrequently, the fund manager does not call for institutional investors to invest their cash immediately when the fund is raised. Rather, institutional investors make contractual, binding commitments to the fund, which are drawn down when required. The commitment period is tied to the life-span of the fund and is therefore made for several years.

In practice in the market, the manager of an institutional closed-end fund will typically only accept commitments from institutional investors with whose covenant it is entirely satisfied i.e. the manager will be confident that the investor will be able to meet commitments to the fund on an almost "on demand" basis (typically on ten business days' notice) even in adverse market conditions[3]. This is in part because investments into private equity funds usually only represent a small percentage of each institutional investor's total assets. Under the constitutional documents of the fund, such commitments are legally enforceable (and default would bring serious adverse consequences for the investor). As a result, the historic experience is that there is no material risk of default on commitments by institutional investors.

Unfortunately, however, under applicable accounting frameworks, such commitments are not typically reflected in the NAV of the fund. Therefore, any measure of leverage (such as GNE) which measures the ratio of exposures (or borrowing) to NAV will give the misleading impression that the fund is leveraged.

We propose that IOSCO should recommend in its final report that a closed-end fund should be excluded from further consideration by regulators at step 1 if its exposures are fully backed by contractual commitments from investors, provided the manager has determined that it believes such commitments would be met by investors including in adverse market conditions. The total of such commitments and NAV would for these purposes constitute "Adjusted NAV". In addition, for the purposes of calculation and reporting of leverage (whether GNE, Adjusted GNE and NNE or otherwise), a closed-end fund should be permitted to measure and report on exposures against Adjusted NAV. This would exclude private equity funds from consideration.

Private equity funds do not use leverage to increase their potential gains by increasing the fund's market exposure beyond its size, as properly measured by reference to commitments, albeit that it may increase the fund's exposure beyond its NAV.

Following this approach would allow regulators to filter out such funds in order to supervise them in a manner which appropriately reflects the fact that they do not give rise to risks to the financial system. It would also enable regulators to design conduct of business frameworks and other regulatory obligations proportionate to the risks.

This last point, about regulatory obligations, is particularly relevant to the members of Invest Europe. Under the EU Alternative Investment Fund Managers Directive, a fund is treated as leveraged if the ratio of its exposures to NAV exceeds 1:1. When a manager of a fund (an AIFM) manages any one fund which is deemed leveraged in this way, a number of additional obligations apply to that manager, which would not otherwise apply. Most important, the de minimis size threshold for small managers exempt from the Directive is much lower (at EUR 100m AUM) than for a manager of only unlevered funds (at EUR 500m). In addition, the

[3] As part of any borrowing facility being entered into, it is usual for the lender to independently check the credit worthiness of the investors that have made commitments to the fund.

application of rules on the remuneration of the manager may be more onerous, the manager may be obliged to maintain liquidity risk management policies and procedures (even though the fund is closed-ended) and the frequency of reporting to regulators is higher. These consequences create a disincentive to managers to take steps which would otherwise be beneficial to the fund and its investors (such as engaging in currency hedging – see below). To avoid similar pitfalls in this regulation, we recommend following this Adjusted NAV approach to properly measure a private equity fund's liquidity risk.

b) Borrowing facilities

Many private equity (and other closed-end) funds may use a borrowing facility to manage cash flows from investors in the fund. This is sometimes known as a "subscription line facility" or "equity call bridge facility". Exposures under such facilities are always backed by uncalled commitments, so this does *not* allow the fund to invest more than its committed capital.

Borrowing beyond the level of contractual commitments for investment purposes is typically contractually prohibited at the fund level, but it may be convenient and commercially desirable for a fund to complete an investment into a portfolio company *before* drawing down the corresponding capital commitment from its own investors. In such a case, it is prudent for the fund to have the ability to use a short-term borrowing facility. This gives the fund manager more flexibility in executing its investment strategy allowing it to more effectively manage the fund's cash flow and to react faster than its investors are able to meet a drawdown request. This avoids unnecessary cash flows to and from the fund and reduces the overall administrative burden for both investors and fund managers.

If the fund borrows at fund level to make an investment, the lender will usually take security over the right of the manager to call uncalled commitments. For this reason, subscription line facilities do not increase the fund's exposure in the traditional sense because the fund will never borrow more that it has available from investors to repay the loan.

We note the IOSCO further suggests the use of other data points that can be used in step 1 to identify funds that may deserve further analysis. If the Adjusted NAV approach is not taken, we recommend including uncalled capital commitments as a supplemental data point in step 1 for closed-end funds, like private equity funds. As described above, without this data point, regulators will be looking at an inaccurate measure of the fund's liquidity risk.

In addition, other asset classes such as (but not limited to) credit funds and infrastructure funds that use closed-end fund vehicles should also be subject to the exemption described above given that they pose a sufficiently minimal level of risk to warrant such exclusion. Credit funds are also structured as limited partnerships where institutional and sophisticated investors make binding capital commitments. They may take on leverage at the fund level, but this leverage often is backed by committed capital and so, depending on the way leverage is measured, some activities, such as hedging or leverage backed by committed capital, may be deemed leverage despite posing no or limited risk. Capital commitments can be used to pay down debts and so must be considered with NAV to accurately determine leverage.

c) Hedging currency risk

Much of the focus of the Paper is on synthetic leverage (i.e. the use of derivatives), which are not typically used in private equity funds except for hedging. As other types of funds, some private equity funds may transact in foreign exchange derivatives. However, these derivatives will generally only be used with the objective of reducing foreign exchange risk when engaging in foreign markets or otherwise transacting in a currency other than the base currency of the fund. Further, in the private equity case, the use of derivatives at the fund level will be backed by the fund's undrawn commitments, yet certain current measures of exposures to NAV currently misleadingly label funds employing such derivatives as leveraged. This would be the case with the GNE or Adjusted GNE methods as suggested in the Paper. However, as acknowledged in the

Paper, foreign exchange derivatives used to hedge exposure to foreign markets and other hedging derivatives do not actually indicate market exposure. Measures like these create a disincentive to hedging, even where hedging may be in the best interests of the fund and investors.

We find that NNE is helpful in the sense that it considers whether derivatives ultimately create a systemic risk or whether they are precisely used to reduce the risk of positions.

iii. Step 2: The relevance of supplementary data points in private equity funds

As for the data points which may be used in the analysis under Step 2, we would like to again stress that many of these will not be relevant in a private equity context.

For example, the concept of standard deviation is one that is problematic for an asset class such as private equity where performance is expressed in terms of internal rates of return based on interim NAVs. A standard deviation method would require reliable market valuations at regular intervals, which a typical private equity fund would be unable to provide.

Overall, the analysis of the fund composition in a private equity context will be fundamentally different from other market players. The success of a private equity fund will not be related to the trading of financial assets but to the individual success of the companies they own.

Nonetheless, some criteria, such as the size of the market as well as the interconnection with other market players may be interesting elements to consider when assessing the risk a fund poses. In our experience, private equity funds have been more resilient than other types of funds, because they tend to be less interconnected to other market participants. Investments in unlisted businesses are less likely to be affected by market movements, and diversification, both from a geographic and industry perspective, accentuates this. There is also evidence that private equity-backed companies are more resilient to market shocks than other private companies.[4]

Private equity funds are also relatively small in size, and investments into private equity funds usually only represent a very small percentage of the institutional investors' total assets. The failure of a fund – or more accurately its inability to return capital drawn down from investors - would therefore only constitute a minor event for these investors, especially as they will usually commit capital to a diversified portfolio of funds.

IV. Conclusion

In conclusion, we support IOSCO's mission, and we strongly believe that excluding private equity (and other types of relevant closed-ended funds) during step 1 of the proposed analysis, or at least including uncommitted capital calls as a supplementary data point, will most effectively achieve an efficient and accurate process for determining leverage risks in investment funds. Thank you for considering these comments. Please see below for direct answers to the questions posed in the Paper.

[4] *See* e.g. Bernstein, Shai, Josh Lerner, and Filippo Mezzanotti. "Private Equity and Financial Fragility during the Crisis." 2018. https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/blm_final_march7.pdf.

II. Step 1: Analysis of potential metrics

Gross notional exposure (GNE)

Question 1: *Do respondents agree with the discussion above concerning the information that can be provided by this metric as well as its limitations?*

We agree with the discussion and believe that GNE is a simplistic measure, especially if used in isolation. Whilst, when used with care and by regulators cognisant of its limitations, it serves a purpose in measuring gross exposures, it has two principal limitations in our industry.

First, by focussing on the ratio of exposures to NAV, it gives a misleading impression about the exposures of closed-end funds where such exposures are fully backed by uncalled commitments from institutional investors (on which please refer to our general comments above). We call for a modified test for closed-end funds which measures exposures to "Adjusted NAV."

Second, and especially in that context, it creates a disincentive to engage in currency hedging, even though this may be in the interests of the fund and its investors.

Question 2: *Do respondents see merit in scoping out of step 1 assessments certain funds, such as for example, smaller funds? Please elaborate.*

As explained in our introductory comments, we strongly believe that closed-end funds whose exposures are fully backed by Adjusted NAV should be scoped out of step 1 assessments.

Following this approach would allow regulators to filter out such funds in order to supervise them in a manner which appropriately reflects the fact that they do not give rise to risks to the financial system. Importantly, it would also enable regulators to design conduct of business frameworks and other regulatory obligations proportionate to the risks posed by such funds. It might also alleviate some of the burdens and costs of more extensive reporting, which are a barrier to new business, innovation, and consequently deployment of capital to the benefit of the real economy.

Question 3: Is this an appropriate metric to use as part of this two-step framework? Does it provide any information that is not provided by the other potential step 1 metrics discussed below?

When used in conjunction with other metrics, with care and by regulators cognisant of its limitations, GNE may serve a valuable purpose. However, in our view, it does not provide any additional information not provided by asking whether a closed-end fund has exposures entirely backed by uncalled commitments from institutional investors.

Even ignoring the capital commitment aspect, we find Adjusted GNE and GNE to be misleading, as they do not take into account hedging. The NNE (discussed further below) does take hedging into account, and therefore, is a more accurate measure of leverage. However, Adjusted GNE and GNE might be beneficial metrics to use in reference to the NNE to ensure NNE is not overly reducing leverage by over estimating the value of hedging and missing residual exposure.

Adjusted GNE

Question 4: *Do respondents agree with the discussion above concerning the information that can be provided by this metric as well as its limitations?*

We believe many of our comments above for GNE reflect our views on Adjusted GNE as well. We do appreciate the efforts to make Adjusted GNE more accurate by adjusting GNE to better calculate the interest rate derivatives' and options' exposures.

Net Notional exposure (NNE)

Question 8: *Do respondents agree that information about a fund's net exposure, when used in conjunction with metrics based on gross market exposure, may provide additional information about a fund's potential leverage? Please elaborate.*

See our answer to question 3 above.

Question 10: Do respondents agree with the proposed conditions of currency hedging arrangements?

We agree generally with the proposed conditions applicable to currency hedging arrangements, subject to two points.

First, the condition about disclosure to investors and regulators must be assessed from time to time, and not at a fixed point on the launch of the fund or its first marketing to investors. A closed-end fund may have a life of ten years or more. It may become appropriate to institute currency hedging only during the life of the fund. Where an institutional fund's constitution permits adjustment to practice around currency hedging (perhaps subject to an investor vote) during its life, then disclosure at that time (in accordance with the fund's constitution) ought to be sufficient to satisfy the condition.

Second, the condition that total notional amounts must not exceed the portfolio's NAV should be adapted in the case of a closed-end fund to measure total notional amounts against Adjusted NAV i.e. NAV plus those undrawn commitments which the manager has formally determined it believes would be met by investors including in adverse market conditions (please refer to our general comments above).

Questions on GNE, Adjusted GNE or NNE

Question 13: GNE represents the gross market exposure of a fund which is calculated by summing the absolutes values of the notional amounts of a fund's derivatives by asset class plus the value of the fund's other investments by asset class, as noted above. Should cash and cash equivalents be included in the calculation of exposure, or not? Please explain.

We believe that all of GNE, Adjusted GNE and NNE should exclude cash and cash equivalents from the calculation of exposures, since these do not give rise to market risks.

Anecdotally, in the EU Alternative Investment Fund Managers Directive, cash is excluded from the calculation under the gross (i.e. GNE) method but included in the calculation of exposures under the commitment method. We believe this is wrong in principle and may be an error in drafting.

Presentation of GNE, Adjusted GNE or NNE by asset class

Question 17: How granular should the split of asset classes be? Would the more granular presentations in Form PF and AIFMD requirements, for example, be most informative? Should the answer depend on the type of fund or regulations that apply to the fund's use of leverage (i.e., more granularity where the regulatory scheme permits greater leverage)? Would allocating exposure across major asset classes such as equities, commodities, credit, interest rates, or currencies, provide sufficient information?

We do not believe that the split of asset classes should be made any more granular because greater granularity fragments the data (inhibiting meaningful comparison), introduces complexity and creates additional reporting burdens. If, contrary to our recommendation, the split of asset classes were to be made more granular, we call for asset class descriptions to take into account the specificities of exposures to assets which are not traded on liquid markets, for example shares in, loans to, and debt securities of unlisted companies.

Questions on supplementary data points

Question 20: *Are there other useful data points that would supplement step 1 metrics? Do respondents consider these or other data points as part of their leverage risk management? If so, which ones and how do respondents use them?*

As said above, we believe private equity funds backed fully by capital commitments should be excluded during step 1 and all closed-end funds should be viewed, under any metric, relative to Adjusted NAV, which is NAV plus any capital commitments yet to be drawn. However, if this is not done, we recommend including capital commitments as a supplementary data point to the step 1 metrics. Without it, regulators would not be getting an accurate view of a closed-end fund's leverage risk (please refer to our general comments above).

Questions on step 1

Question 21
a) Should we consider other metrics than the one consulted on? If so, which one(s) and why?
b) What's your view of the metrics detailed in appendix B?

See our comments above as to metrics (or adjustments to the current metrics) we believe should apply to closed-end funds.

III. Articulation of one or more step 1 metrics

Question 22: Do respondents agree that none of the metrics analysed can alone provide an accurate measure of leverage of a given fund or a group of funds? Would a combination of the suggested metrics or one of such metrics with supplementary data point suffice to meaningfully monitor leverage and identify funds that may need further risk assessment regardless of the market conditions? Please elaborate.

We agree, and we favour a combination of metrics.

As we mentioned in our introductory comments, conduct of business rules and other regulatory obligations should also not be tied to any single metric. For example, under the EU Alternative Investment Fund Managers Directive at present, certain regulatory obligations apply to the manager of a fund if that fund is considered to be leveraged (at all, irrespective of degree) under either the gross or commitment method tests.

Question 23: What are the challenges associated with the collection of data for each metric and/or of the supplementary data points suggested? Is the information readily available?

Reporting by fund managers inevitably brings costs and burdens. This is why we recommend scoping out certain closed-end funds at step 1.

Contact

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About the AIC

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 responsible 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, 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.

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 25 employees in Brussels, Belgium.

For more information please visit www.investeurope.eu.