PRIVATE EQUITY GROWTH CAPITAL COUNCIL

EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL ASSOCIATION
CREATING LASTING VALUE

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

May 29, 2015

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

Re: FINANCIAL STABILITY BOARD AND INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, "Proposed Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (Mar. 4, 2015)

Ladies and Gentlemen:

These comments are submitted by the Private Equity Growth Capital Council (the "PEGCC")[1] and the European Private Equity and Venture Capital Association ("EVCA").[2] The PEGCC, based in Washington, DC, is an advocacy, communications and research organization established to develop, analyze and distribute information about the private equity and growth capital (together, "private equity") industry and its contributions to the national and global economy. Our members represent a broad cross section of the private equity industry in the United States and include many of the world's largest and best known private equity firms, as well as leading small and medium-sized private equity firms. Our members are united by their commitment to growing and strengthening the businesses in which they invest. For further information about the PEGCC and its members, please see our website at www.pegcc.org.

The EVCA is the voice of European private equity. The EVCA's membership covers the full range of private equity activity, from early-stage venture capital to the largest private equity firms and infrastructure funds, investors such as pension funds, insurance companies, fund-of-funds and family offices and associate members from related professions. Based in Brussels, the EVCA represents 700 member firms and 500

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affiliate members. The EVCA shapes the future direction of the industry, while promoting it to stakeholders such as entrepreneurs, business owners and employee representatives.

The PEGCC and EVCA appreciate the opportunity to provide their comments to the Financial Stability Board ("FSB") and the International Organization of Securities Commissions ("IOSCO") on the second consultative document, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies" (the "Proposed Framework").[3] This letter first provides an executive summary of our comments, then describes our views of the features of the Proposed Framework, and finally discusses the reasons that private equity firms and funds are not systemically important.

I. Executive Summary

The PEGCC and EVCA believe that effective assessment methodologies to identify global systemically important non-bank, non-insurer financial entities ("NBNI entities") can be developed through the close cooperation of the FSB, IOSCO, NBNI entities and other relevant stakeholders. As the PEGCC noted at several points during the regulatory process regarding systemically important financial institutions in the United States, private equity firms and funds are not systemically important.[4] Similarly, we believe that any assessment methodology that effectively and accurately identifies global systemically important NBNI entities will conclude that private equity firms and the

[3] FSB, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, 2nd Consultative Document (Mar. 4, 2015), *available at* http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf

[4] See 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); see also 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).

private equity funds that they and their affiliates advise do not present any systemic risk to the global financial system and economic activity across jurisdictions.

The PEGCC and EVCA have discussed many of the areas of focus contained in this letter in greater detail in our prior submission commenting on the FSB and IOSCO's initial consultative document regarding the proposed NBNI assessment methodologies.[5] In addition, in our prior submission we presented our views on each of the proposed assessment factors, which include size, interconnectedness, substitutability, complexity, and cross-jurisdictional activities. For your convenience, we have attached our prior submission here as Appendix A, and we resubmit those comments as part of this letter.

II. The Proposed Framework

The PEGCC and EVCA believe a well-designed assessment methodology for identifying global systemically important NBNI entities must take into account the following fundamental concerns.

- *Assessment Methodology Should Focus on Investment Funds Individually.* The PEGCC and EVCA believe the assessment methodology should focus on investment funds individually. The prior version of the proposed methodology correctly took this route and the PEGCC and EVCA believe the change in course is unwarranted, not fully explained and should be revised. Individual investment funds, even those that share the same sponsor or manager, are formed as structurally separate entities and generally pursue or hold different investments, have different sets of investors and do not provide for cross-collateralization or cross-guarantees between funds. In addition, private equity funds do not offer redemptions in the ordinary course of business. For these reasons, there is no opportunity for a theoretical "run" to occur on any one fund or to spread to an affiliated fund or the manager itself. Because the funds that a firm manages are separate legal entities with no cross-collateralization or cross-guarantees between different funds, the manager should not be a focus of designations.

- *Private Equity Funds Are Not Systemically Important.* Private equity funds attract long-term investors, who do not have the ability to redeem in the ordinary course of business, and primarily make long-term investments in unlisted portfolio companies. Therefore, there is no maturity or liquidity transformation and no risk of a "fire sale." Furthermore, private equity funds operate in a highly competitive market of other private equity funds as well as a wide range of other market

[5] PEGCC and EVCA Comment Letter of Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Apr. 7, 2014).

participants. Finally, private equity funds have only limited connections with other financial institutions (other than their equity investors), since private equity funds generally have limited or no borrowing at the fund level.

- *Materiality Thresholds*. Under the proposal, gross notional exposure ("GNE") is used as the materiality threshold for private funds. The PEGCC and EVCA believe that the methodology should clarify that GNE only includes leverage at the fund (as compared to portfolio company) level. As noted above, the PEGCC and EVCA do not believe asset managers should be covered by the methodology, but if they are, assets under management ("AUM") is not an appropriate metric for a materiality threshold. Instead, as with individual funds, the materiality threshold should focus on a firm's proprietary assets at risk of loss, which would represent the total amount that a particular firm might lose in the event that the firm and all of the funds it advises were to liquidate. Further, the final methodology should automatically raise the materiality thresholds periodically to account for normal economic inflation.

III. Private Equity Funds and Firms are Not Systemically Important

The stated objective of the assessment methodologies is the designation of NBNI entities "whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity."[6] Because private equity funds do not, for the reasons described in this letter, present the potential to cause such disruptions, an effective and accurate assessment should show that they are not systemically important under the Proposed Framework.

As an initial matter, the PEGCC and EVCA strongly support the FSB and IOSCO's recognition that investment funds present very different risk profiles compared to other types of financial entities.[7] Investors in private equity funds knowingly accept investment risk in connection with the possibility of potentially significant returns (unlike a person depositing money in an insured bank account). Such risk, willingly entered into, is an essential component of the market economy.

Furthermore, there is no maturity or liquidity transformation—private equity funds have long-term investors (with no redemption rights in the ordinary course of business), invest in long-term securities and generally only return capital to investors

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6 Proposed Framework at 1.

7 *Id.* at 4.

upon a realization of an investment (and generally do so within a relatively short period after realization).

The structure of private equity firms and funds and the conduct of their businesses, as a class and individually, do not present systemic risk concerns for the following reasons.

No General Redemption Rights. Investors in private equity firms and funds do not have redemption or withdrawal rights that would enable those investors to force a fire sale of assets were those investors to attempt to make a "run on the bank." In addition, private equity funds are funded with long-term, contractually binding, capital commitments and do not rely on short-term credit. Private equity firms and funds, therefore, do not face liquidity concerns that could result in forced asset sales to meet investor (or other) claims—and which in turn could drive down investment values, thereby adversely affecting other financial system participants.

Limited Leverage. Private equity firms and funds (other than certain real estate and debt funds operated by some private equity firms, and other than short-term debt used to bridge capital calls and otherwise backed by capital commitments) typically engage in limited or no borrowing. Indeed, (1) many fund governing documents limit the amount of borrowing that a fund may incur, and (2) most private equity funds have little or no current income to service debt even if they are permitted to borrow. Although portfolio companies frequently borrow, there is evidence that the average default rate for private equity portfolio companies is lower than the average default rate for non-private equity backed companies.[8] And as each portfolio company is legally separated from the fund, its investors, and from other portfolio companies, any leverage at this level does not have any systemic implications.

No Substitutability Concerns. Private equity firms and funds do not present substitutability concerns because—although they play an important role in the economy and help grow and strengthen the businesses in which they invest—such firms and funds do not themselves provide the kinds of products, services or infrastructure that are necessary for the functioning of the financial system (such as consumer credit, clearance and settlement services, or legally required insurance products) and that other institutions cannot readily provide. Nor will the companies that receive private equity backing generally raise such issues. While private equity firms and funds are important sources

[8] 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-therecord- 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").

of equity investment in the businesses they back, those businesses will always have alternative sources of finance.

Limited Financial System Interconnectedness. Private equity firms and funds are not deeply interconnected with banks or with other nonbank financial companies, including by virtue of: limited or no fund-level leverage (as discussed above); limited or no derivatives positions; limited counterparty exposure relating to, for example, swaps (other than possibly currency and interest rate swaps contracts entered into for normal risk management purposes) or securities lending; and limited or no reliance on short-term credit for their operations or provision of credit to financial system participants. Furthermore, private equity firms and funds are not interconnected with each other, because they neither pledge their assets as security for, nor do they guarantee, each other's obligations. For the same reasons, the failure of any particular portfolio company will 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. Therefore, the failure of a private equity firm or fund would not create cascading negative effects on other parts of the financial system.

Relatively Small Size. Very large financial firms, such as banks, that are interconnected with other financial firms are likely to have larger spillover effects should they fail than would smaller firms. Private equity firms and funds both are not deeply interconnected with banks and other non-bank financial companies, and are relatively small in size compared to large banks, insurance companies, and broker-dealers. For example, the largest private equity fund known to us has capital commitments of just over $21 billion, and most private equity funds are significantly smaller, as compared to the largest bank holding companies that have over a trillion dollars in assets.

Systemic Risk Transmission Channels. In the Proposed Framework, the FSB and IOSCO identify three systemic risk transmission channels applicable to investment funds generally: exposures / counterparty; asset liquidation / market; and critical function or services / substitutability. The PEGCC and EVCA agree that these are the correct channels on which the FSB and IOSCO should focus and believes that none of these channels are applicable to private equity funds.

To this end, the PEGCC and EVCA reiterate that the third channel -- "critical function or services / substitutability" transmission -- which may apply to other NBNI firms, is not applicable to investment funds (as was indicated in FSB and IOSCO's January 2014 consultative document), as investment funds operate in a highly competitive market and perform no critical functions that could not be offered by a competitor in the market.

Private equity funds do not present significant exposure or counterparty risks, as the funds themselves typically have very limited connections to other parties (excluding their own equity investors, who are knowingly taking investment risk). To the limited extent that private equity funds would have counterparty exposures to financial entities, such counterparties are themselves often subject to risk-mitigating regulations reflecting *their* respective systemic risk profile. For these reasons, we believe that private equity funds do not present global systemic risks through the "exposures / counterparty" transmission channel as discussed by the FSB and IOSCO.

The "asset liquidation / market" transmission channel, which describes the indirect impact from the distress or failure of an investment fund on other market participants, is also inapplicable to private equity funds. Such funds are generally capitalized in a manner that matches their funding needs (i.e., long-term equity investors with no redemption rights in the ordinary course of business) with their long-term assets, eliminating any maturity mismatch and thereby external pressure to engage in the forced sale of assets. Further, the assets held by such funds are typically privately-offered securities in a limited number of operating companies, and thus any sale of fund assets is unlikely to cause distortions in market liquidity and/or prices that could lead to indirect distress to other market participants.

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The PEGCC and EVCA appreciate the opportunity to comment on the Proposed Framework 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,

Steve Judge
President and CEO
Private Equity Growth Capital Council

Dörte Höppner
Chief Executive
European Private Equity and
Venture Capital Association

Appendix A

April 7, 2014

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

Re: FINANCIAL STABILITY BOARD AND INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (Jan. 8, 2014)

Dear Chairman Mark Carney:

The Private Equity Growth Capital Council ("PEGCC")[9] and the European Private Equity and Venture Capital Association ("EVCA")[10] appreciate the opportunity to provide their comments to the Financial Stability Board ("FSB") and the International Organization of Securities Commissions ("IOSCO") on the consultative document, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies" (the "Proposed Framework").[11]

The PEGCC is an advocacy, communications and research organization and resource center established to develop, analyze and distribute information about the private equity and growth capital investment industry and its contributions to the national

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[10] European Private Equity & Venture Capital Association, Bastion Tower, Place du Champ de Mars 5, B-1050, Brussels, Belgium, Phone : +32 2 715 00 20, Fax : +32 2 725 07 04, www.evca.eu.

[11] FSB, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Jan. 8, 2014), *available at* http://www.financialstabilityboard.org/publications/r_140108.pdf.

and global economy. Established in 2007 and formerly known as the Private Equity Council, the PEGCC is based in Washington, D.C. The members of the PEGCC 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.

The EVCA is the voice of European private equity. The EVCA's membership covers the full range of private equity activity, from early-stage venture capital to the largest private equity firms, investors such as pension funds, insurance companies, fund-of-funds and family offices and associate members from related professions. Based in Brussels, the EVCA represents 700 member firms and 500 affiliate members. The EVCA shapes the future direction of the industry, while promoting it to stakeholders such as entrepreneurs, business owners and employee representatives.

IV. Executive Summary

The PEGCC and EVCA believe that effective assessment methodologies to identify global systemically important non-bank, non-insurer financial entities ("NBNI entities")[12] can be developed through the close cooperation of the FSB, IOSCO, NBNI entities and other relevant stakeholders. As we noted at several points during the regulatory process regarding systemically important financial institutions in the United States and in Europe, private equity firms and funds are not systemically important.[13] Similarly, we believe that any assessment methodology that effectively and accurately identifies global systemically important NBNI entities will conclude that private equity firms and the private equity and credit drawdown funds ("private equity funds")[14] that they and their affiliates advise do not present a systemic risk to the global financial system and economic activity across jurisdictions. We discuss the application of the Proposed Framework to private equity firms and funds below and, in the Appendix, include specific responses to the applicable questions posed by FSB and IOSCO.

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12 G20 Cannes Declaration (Nov. 2011).

13 *See, e.g.*, Comment Letter of the PEGCC on the US Financial Stability Oversight Council's Second NPRM Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (Dec. 16, 2011); Submission of the EVCA to the European Commission Internal Market and Services DG in Response to the Consultation on the Recommendations of the High-level Expert Group on Reforming the Structure of the EU Banking Sector (Nov. 13, 2012).

14 For purposes of this memorandum, we include both traditional private equity funds (which principally invest in the equity of portfolio companies) and credit drawdown funds (which principally invest in the debt of portfolio companies). The structure of both funds is fundamentally the same for purposes of global systemic risk analysis, including, among other things, the fact that neither type of fund permits redemptions in the ordinary course of business.

- *Assessment Methodology Should Focus on Investment Funds Individually.* The PEGCC and EVCA strongly support the FSB and IOSCO's decision to focus the assessment methodology on investment funds individually. Individual investment funds, even those that share the same sponsor or manager, are formed as structurally separate entities and generally pursue or hold different investments, have different sets of investors and do not provide for cross-collateralization or cross-guarantees between funds. In particular, private equity funds do not offer redemptions in the ordinary course of business; thus, there is no opportunity for a theoretical "run" to occur on any one fund or to spread to an affiliated fund or the manager itself.

- *Investment Advisers and Managers Are Not Market Intermediaries.* The PEGCC and EVCA believe that the FSB and IOSCO should clarify that an investment adviser or investment manager primarily in the business of providing investment advice is not a "market intermediary" for purposes of the Proposed Framework. Investment advisers and investment managers act as agents on behalf of their clients (including investment funds) and—to the extent they do so at all—do not engage in significant levels of proprietary trading, do not utilize meaningful leverage at the firm level and are not significant counterparties with other financial institutions or participants in the financial markets.

- *Private Equity Funds Are Not Systemically Important.* Private equity funds attract long-term investors, who do not have the ability to redeem in the ordinary course of business, and primarily make long-term investments in unlisted portfolio companies. Therefore, there is no maturity or liquidity transformation and no risk of a "fire sale." Furthermore, private equity funds operate in a highly competitive market of other private equity funds as well as a range of other market participants, including strategic buyers. Finally, private equity funds have only limited connections with other financial institutions (other than their equity investors), since private equity funds generally incur little or no leverage at the fund level.

- *The Materiality Threshold.* The PEGCC and EVCA believe that materiality threshold is too low considering the G-SIBs that have already been designated and the decreased global systemic risks that investment funds present. Net asset value ("NAV") (excluding uncalled capital commitments) is an appropriate metric for size of a fund, because it would appropriately measure the assets at risk of a fund (*i.e.*, the assets that would be at risk in the event of a liquidation of the fund). However, if the FSB and IOSCO decide to focus on asset managers instead of individual funds, assets under management is not an appropriate measure of size,

since it does not accurately convey the assets at risk in the event of the liquidation of the asset manager. Finally, if the FSB and IOSCO decide to include a measure of leverage for purposes of determining the materiality of an investment fund, the PEGCC and EVCA believe that the measure of leverage should not include leverage incurred at the portfolio company level, since the investment fund is generally insulated from the risks of that leverage.[15]

V. The Proposed Framework Correctly Focuses on Investment Funds Individually.

The PEGCC and EVCA strongly support the FSB and IOSCO's decision to focus the assessment methodology on investment funds individually and not (i) a family of funds, (ii) an asset manager on a stand-alone basis, or (iii) an asset manager and its funds collectively.

Funds sponsored by a private equity manager are structurally and operationally separate from each other, even in bankruptcy, as each fund is organized as a separate legal entity, generally pursues or holds different investments, has different sets of investors and does not provide cross-collateralization or cross-guarantees for other funds managed by the same manager.[16] Because of this structural and operational separation, any assessment of funds as a family would inappropriately aggregate data and result in a distorted and exaggerated representation of potential global systemic significance.

A private equity firm's investment in a sponsored fund is structured to limit the liability exposure of the firm, which exposure is generally restricted to a small ownership interest. Thus, private equity firms are not exposed to or otherwise connected to the fund-related risk transmission channels identified by the FSB and IOSCO.

Finally, the rationale supporting the assessment of an asset manager and its funds collectively – that a failure of one fund could cause a "run" on other affiliated funds – is inapplicable in the context of private equity funds, as they cannot be susceptible to runs

[15] Furthermore, the portfolio companies and other investments owned by individual funds are structurally independent of each other, since there is typically no cross-collateralization or cross-guarantee in place between the portfolio companies or other investments of a private equity fund.

[16] As noted, *supra* note 15, portfolio companies and other investments held by a private equity fund are also structurally independent of each other.

because they do not permit redemptions in the ordinary course of business. Further, as noted by the FSB and IOSCO, such a risk is purely theoretical.[17]

VI. Private Equity Firms Are Not "Market Intermediaries."

The PEGCC and EVCA are concerned that, as currently defined, investment advisers and managers may be captured by the definition of "market intermediary" in the Proposed Framework.[18] The FSB and IOSCO do not explain why investment advisory activities are related to the global systemic risks posed by market intermediaries, as described in the Proposed Framework.

Private equity firms, like most investment advisers, do not hold substantial amounts of assets on their balance sheet, do not utilize meaningful leverage at the firm-level, do not have significant exposures to counterparties, do not execute securities transactions with customers or otherwise provide market liquidity and participate in a highly competitive market where no individual firm has systemically significant market share. The PEGCC and EVCA recommend that the definition be clarified so that it no longer includes entities that are primarily in the business of acting as investment advisers.

VII. Private Equity Funds are Not Systemically Important.

We understand the objective of the assessment methodologies to be the designation of NBNI entities "whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity."[19] Because private equity funds do not, for the reasons described in this letter, present the potential to cause such disruptions, an effective and accurate assessment should show that they are not globally systemically important under the Proposed Framework.

As an initial matter, the PEGCC and EVCA strongly support the FSB and IOSCO's recognition that investment funds present very different risk profiles compared to other types of financial entities. Investors in private equity funds accept investment

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[17] Proposed Framework at 32 ("Theoretically, reputational risk of an asset manager or one of the funds it manages may create runs both on the asset manager as well as on its funds").

[18] Proposed Framework at 21 (including in the definition of "market intermediary" any of a set of activities including "providing advice regarding the value of securities or the advisability of investing in, purchasing, or selling securities").

[19] Proposed Framework at 1.

risk in connection with the possibility of potentially significant returns (unlike a person depositing money in an insured bank account). Thus, as the FSB and IOSCO recognized, investment funds, unlike banks, have an inherent "shock absorber" because fund investors absorb losses as well as gains. Furthermore, there is no maturity or liquidity transformation—private equity funds have long-term investors (with no redemption rights in the ordinary course of business), invest in long-term securities and generally only return capital to investors upon a realization of an investment (and generally do so within a relatively short period after realization).[20]

In the Proposed Framework, the FSB and IOSCO identify two systemic risk transmission channels applicable to investment funds generally. The PEGCC and EVCA agree that these are the correct channels on which the FSB and IOSCO should focus and believes that neither channel is applicable to private equity funds. To this end, the PEGCC and EVCA agree with the FSB and IOSCO that the third channel -- "critical function / substitutability" transmission -- which may apply to other NBNI firms, is not applicable to investment funds, as investment funds operate in a highly competitive market and perform no critical functions that could not be offered by a competitor in the market.

Private equity funds do not present significant exposure or counterparty risks, as the funds themselves typically have very limited connections to other parties (excluding their own equity investors). To the limited extent that private equity funds would have counterparty exposures to financial entities, such counterparties are themselves often subject to risk-mitigating regulations. For these reasons, we believe that private equity funds do not present global systemic risks through the "exposures / counterparty" transmission channel as discussed by the FSB and IOSCO.

The "asset liquidation / market" transmission channel, which describes the indirect impact from the distress or failure of an investment fund on other market participants, is also inapplicable to private equity funds. Such funds are generally capitalized in a manner that matches their funding needs (*i.e.*, long-term equity investors with no redemption rights in the ordinary course of business) with their long-term assets, eliminating any maturity mismatch and thereby external pressure to engage in the forced sale of assets. Further, the assets held by such funds are typically privately-offered securities in a limited number of operating companies, and thus any sale of fund assets, even at "fire sale" prices, is unlikely to cause distortions in market liquidity and/or prices that could lead to indirect distress to other market participants.

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[20] As discussed *supra* note 14 and the accompanying text, this analysis applies both to traditional private equity funds and credit drawdown funds.

VIII. The Assessment Methodology for Investment Funds Should Be Revised To Better Distinguish between Risks Arising from Different Types of Investment Activities

The PEGCC and EVCA believe that the assessment methodology should be calibrated to focus on those impact factors and indicators that appropriately capture when an investment fund could cause a material disruption to the global financial system.

A. *Materiality Threshold*

The PEGCC and EVCA believe that the current materiality threshold for investment funds is too low, particularly when considering that (i) the smallest G-SIB has total assets greater than $200 billion and (ii) investment funds and, in particular, private equity funds present significantly reduced risks compared to G-SIBs. For this reason, the PEGCC and EVCA believe that the materiality threshold for investment funds should be set higher than $200 billion. Regardless of where the threshold is set, the materiality threshold should not be a static designation but rather should be pegged to an appropriate measurement of the growth of the financial system**.**

The PEGCC and EVCA believe that, with respect to the materiality threshold or any other purpose, the appropriate measure of size should be the total amount that the entity might lose in the event that it liquidates. With respect to a fund, we believe that the NAV is an appropriate measure of this potential loss. The FSB and IOSCO should clarify that this net asset value does not include uncalled capital commitments, since these assets would not be at risk in the event of a liquidation of the fund.

As noted above, the PEGCC and EVCA do not believe that the evaluation should take place at the asset manager level. However, if any such calculation takes place, we do not believe that the assets under management of an asset manager is an appropriate metric. Rather, as with individual funds, the calculation should focus on the total amount that the firm might lose in the event that the firm and all of the funds it advises were to liquidate.

If the FSB and IOSCO also evaluate leverage (along with size) at the materiality threshold stage, the PEGCC and EVCA believe that any such measurement of leverage should include only unsecured, long-term leverage (*e.g.*, short-term financing or bridge financing that is fully secured by investor capital should not be included) that is incurred by the fund or for which there is recourse to the fund because, for example, the fund has issued a guarantee. Private equity funds themselves generally do not incur any significant leverage and do not guarantee leverage that might be incurred by the portfolio companies of the funds. Therefore, the failure of a portfolio company would not have any impact on any of the other portfolio companies of a private equity fund or on the

fund itself, other than its loss of its equity investment.[21] For these reasons, it would not be appropriate to consider portfolio company leverage at the materiality threshold or at any other stage in the analysis.

B. *Specific Assessment Factors*

In the United States, the PEGCC has supported an assessment methodology based on such indicators as size, substitutability, and interconnectedness in the past.[22] The PEGCC and EVCA continue to believe that application of such indicators as proposed by the FSB and IOSCO (*i.e.*, the sector-specific indicators for investment funds) are generally appropriate and demonstrate that private equity funds do not present global systemic risk concerns.

1. *Size*

The PEGCC and EVCA believe that NAV is an appropriate measure for the size of private equity funds, but that fund size alone is not an effective indicator of global systemic importance. As noted above, the PEGCC and EVCA believe that the size should be calculated at the fund level; however, if the size is calculated at the asset manager level, the relevant size of the asset manager should be calculated as the amount of the total amount that the private equity firm might lose in the event that the firm and all of the funds it advisers were to liquidate.

2. *Interconnectedness*

The PEGCC and EVCA support assessing interconnectedness as a factor in determining global systemic importance. Private equity funds typically have very low exposures to other parties and few counterparties, since, among other things, the funds do not engage in a significant amount of borrowing or trading in derivatives at the fund level. Thus, the proposed indicators (leverage ratio, counterparty exposure ratio or the intra-financial system liabilities) would be very low for private equity funds.

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[21] As noted, *supra* note 15, portfolio companies and other investments held by a private equity fund are also structurally independent of each other.

[22] Comment Letter of the PEGCC on FSOC's Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (FSOC-2011-0001) (Feb. 25, 2011).

3. *Substitutability*

The PEGCC and EVCA agree with the FSB and IOSCO that "most investment funds are generally substitutable."[23] We emphasize that private equity funds are highly substitutable, as there are many funds pursuing similar investment goals and holding substantially similar asset classes, namely long-term, strategic investments in privately-offered securities. As such, we expect that all private equity funds would be regarded as highly substitutable under an assessment methodology.

We believe that the FSB and IOSCO should apply an analysis of the proposed fund-specific indicators (turnover of the fund related to a specific asset, the total fund turnover vs. total turnover of similar funds and investment strategies with less than 10 market players) only where the asset, directly or indirectly, relates to a critical function or service. As proposed, it is unclear how these indicators would be applied to the typical assets of a private equity fund, which are long-term investments in privately-offered securities issued by companies that do not perform critical functions or services.

In addition, in defining the "market" in which private equity funds operate, the FSB and IOSCO should recognize that private equity funds are in competition for both investors in the funds as well as investment opportunities for the funds. Private equity funds compete for investors not only with other private equity funds but also with a wide range of other investment vehicles that pursue long-term investment strategies. Similarly, in identifying and realizing investment opportunities, private equity funds compete in a market comprising a wide variety of strategic investors, not only other private equity funds. Thus, the PEGCC and EVCA believe that an assessment of the "market" in which private equity funds operate, for purposes of evaluating the funds' substitutability, should include the wide range of market actors in both the capital-raising and capital-investing aspects of the funds' operations.

4. *Complexity*

The PEGCC and EVCA believe that complexity is an important factor in determining global systemic importance; however, the proposed indicators show that private equity funds are not complex. In reviewing the FSB and IOSCO's proposed fund-specific indicators of complexity (OTC derivative trade volume, ratio of posted collateral, ratio of high frequency trading strategies, portfolio liquidity compared to investor liquidity, ratio of unencumbered cash to gross notional exposure), the PEGCC and EVCA note that all of these appear to focus on investment funds engaged in trading

[23] Proposed Framework at 34.

activities significantly different from a private equity fund. A private equity fund does not engage in a significant volume of derivative trading, does not generally pursue strategies that require posted collateral, makes a limited number of long-term investments that are often highly negotiated (and therefore the opposite of high frequency trading), issues illiquid securities and invests in illiquid assets and does not incur significant long-term or unsecured leverage at the fund level.

5. *Cross-Jurisdictional Activities*

The PEGCC and EVCA do not believe that a simple count of the number of jurisdictions in which a fund invests, offers interests, or has counterparties or investors is an accurate measure of cross-jurisdictional importance. We further note that geographic diversification may reduce the risks faced by the fund. These indicators should be revised to reflect the relative risk posed by the activities in each jurisdiction. For example, private equity funds' cross-jurisdictional activities are mostly limited to passive equity interests, such as the fund owning stock in a portfolio company or an investor owning an interest in the private equity fund. The fact that these activities actually pose limited risk to the global financial system indicates that they should not be included in any assessment of an investment fund's cross-jurisdictional activities.

Therefore, the PEGCC and EVCA believe that the focus of cross-jurisdictional activities should be limited to exposure to counterparties in other jurisdictions. As noted above, private equity funds have limited exposure to counterparties in any jurisdiction and, therefore, do not engage in the types of cross-jurisdictional activities that may spread systemic risk across different jurisdictions.

IX. Separately Managed Accounts Do Not Present Systemic Risks

The FSB and IOSCO state that separately managed accounts ("SMAs")[24] are not currently included in the Proposed Framework but should be subject to future assessment. The PEGCC and EVCA believe that any such assessment is unnecessary because of the inherent characteristics of SMAs. In particular, any assets held in SMAs are completely segregated from the assets of the private equity firm and funds sponsored by the private equity firm; therefore, the risks associated with a SMA are wholly attributable to the investor for whom the SMA was created. Just as with all investment funds, investors in

[24] Investment advice to an SMA may take several different forms, including providing investment advice to an account maintained at a third-party custodian over which the client has direct legal ownership or providing advice through a general partner to a limited partnership of which the client is the sole limited partner. There is no difference in the potential global systemic risks in these arrangements.

SMAs are seeking investment opportunities in order to receive a commensurate return on their invested capital.

Furthermore, unlike retail SMAs or SMAs pursuing investments in public securities, SMAs advised by private equity firms are generally highly negotiated and pursue customized investment strategies. These SMAs also have the same essential characteristics of private equity funds—they engage in long-term investing, utilize only a small amount of leverage at the account level, and do not engage in significant amounts of trading in derivatives. In addition, because of the structure of SMAs, the private equity firm advising the SMA is substitutable. Taken together, SMAs pursuing private equity strategies would not be globally systemically risky.

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The PEGCC and EVCA appreciate the opportunity to comment on the proposed rule 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,

Steve Judge
President and CEO
Private Equity Growth Capital Council

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Chief Executive
European Private Equity and Venture Capital Association

APPENDIX - PEGCC and EVCA's Responses to Questions Posed in the Proposed Framework

In this appendix, we use the term "private equity fund" to include both traditional private equity funds (which principally invest in the equity of portfolio companies) and credit drawdown funds (which principally invest in the debt of portfolio companies). The structure of both funds is fundamentally the same for purposes of global systemic risk analysis, including, among other things, the fact that neither type of fund permits redemptions in the ordinary course of business.

Operational framework for NBNI G-SIFI methodologies

Q3-2. In your view, are the above proposed materiality thresholds (including the level) for the NBNI financial entity types appropriate for providing an initial filter of the NBNI financial universe and limiting the pool of firms for which more detailed data will be collected and to which the sector-specific methodology will be applied? If not, please provide alternative proposals for a more appropriate initial filter (with quantitative data to back-up such proposals).

The PEGCC and EVCA believe that the current materiality threshold for investment funds is too low, particularly when considering that (i) the smallest G-SIB has total assets greater than $200 billion and (ii) investment funds and, in particular, private equity funds present significantly reduced risks compared to G-SIBs. For this reason, the PEGCC and EVCA believe that the materiality threshold for investment funds should be set higher than $200 billion. Regardless of where the threshold is set, the materiality threshold should not be a static designation but rather should be pegged to an appropriate measurement of the growth of the financial system**.**

The PEGCC and EVCA believe that, with respect to the materiality threshold or any other purpose, the appropriate measure of size should be the total amount that the entity might lose in the event that it liquidates. With respect to a fund, we believe that the NAV is an appropriate measure of this potential loss. The FSB and IOSCO should clarify that this net asset value does not include uncalled capital commitments, since these assets would not be at risk in the event of a liquidation of the fund.

As noted above, the PEGCC and EVCA do not believe that the evaluation should take place at the asset manager level. However, if any such calculation takes place, we do not believe that the assets under management of an asset manager is an appropriate metric. Rather, as with individual funds, the calculation should focus on the total amount

that the firm might lose in the event that the firm and all of the funds it advises were to liquidate.

If the FSB and IOSCO also evaluate leverage (along with size) at the materiality threshold stage, the PEGCC and EVCA believe that any such measurement of leverage should include only unsecured, long-term leverage (*e.g.*, short-term financing or bridge financing that is fully secured by investor capital should not be included) that is incurred by the fund or for which there is recourse to the fund because, for example, the fund has issued a guarantee. While portfolio companies of private equity funds may incur leverage, the private equity funds themselves generally do not incur any significant leverage and do not guarantee leverage incurred at the portfolio company. Therefore, the failure of a portfolio company does not have any impact on any of the other portfolio companies of a private equity fund or on the fund itself, other than its loss of its equity investment.[25] For these reasons, it would not be appropriate to consider portfolio company leverage at the materiality threshold or at any other stage in the analysis.

Sector-specific methodologies (2): Market intermediaries (Securities broker-dealers)

Q5-1. In your view, does the proposed definition of market intermediaries provide a practical basis for applying the specific methodology (i.e. indicators) to assess the systemic importance of NBNI financial entities that fall under the definition?

The PEGCC and EVCA are concerned that, as currently defined, investment advisers may be captured by the definition of "market intermediary" in the Proposed Framework. The FSB and IOSCO do not explain why investment advisory activities are related to the global systemic risks posed by market intermediaries, as described in the Proposed Framework.

Private equity firms, like most investment advisers, do not hold substantial amount of assets on their balance sheet, do not utilize meaningful leverage at the firm-level, do not have significant exposures to counterparties and participate in a highly competitive market where no individual firm has systemically significant market share. The PEGCC and EVCA recommend that the definition be clarified so that it no longer includes entities that are primarily in the business of acting as investment advisers.

[25] As noted, *supra* note 15, portfolio companies and other investments held by a private equity fund are also structurally independent of each other.

Sector-specific methodologies (3): Investment funds

Q6-1. In your view, does the proposed definition of investment funds provide a practical basis for applying the specific methodology (i.e. indicators) to assess the systemic importance of NBNI financial entities that fall under the definition?

The PEGCC and EVCA have no comments on the application of the definition of "investment funds" in the Proposed Framework with respect to private equity funds.[26]

Q6-2. Does the above description of systemic importance of asset management entities adequately capture potential systemic risks associated with their financial distress or disorderly failure at the global level?

The PEGCC and EVCA strongly support the FSB and IOSCO's recognition that investment funds present very different risk profiles compared to other types of financial entities. Investors in private equity funds expect investment risk in connection with the possibility of significant returns (unlike a person depositing money in an insured bank account). Thus, as the FSB and IOSCO recognized, investment funds, unlike banks, have an inherent "shock absorber" because fund investors absorb losses as well as gains. Furthermore, there is no maturity or liquidity transformation—private equity funds have long-term investors (with no redemptions in the ordinary course of business) and invest in long-term securities.

In the Proposed Framework, the FSB and IOSCO identify two systemic risk transmission channels applicable to investment funds generally. The PEGCC and EVCA agree that these are the correct channels on which the FSB and IOSCO should focus and believes that neither channel is applicable to private equity funds. To this end, the PEGCC and EVCA agree with the FSB and IOSCO that the third channel -- "critical function / substitutability" transmission -- which may apply to other NBNI firms, is not applicable to investment funds, as investment funds operate in a highly competitive market and perform no critical functions that could not be offered by a competitor in the market.

For the reasons set out in our comment letter, the PEGCC and EVCA believe that private equity funds are not globally systemically important under this description.

[26] As noted, *supra* note 14, we use the term "private equity funds" to include both traditional private equity funds and credit drawdown funds.

Q6-3. Which of the following four levels of focus is appropriate for assessing the systemic importance of asset management entities: (i) individual investment funds; (ii) family of funds; (iii) asset managers on a stand-alone entity basis; and (iv) asset managers and their funds collectively? Please also explain the reasons why you think the chosen level of focus is more appropriate than others.

The PEGCC and EVCA strongly support the FSB and IOSCO's decision to focus the assessment methodology on investment funds individually and not (i) a family of funds, (ii) an asset manager on a stand-alone basis, or (iii) an asset manager and its funds collectively.

Funds sponsored by a private equity manager are independent of each other, even in bankruptcy, as funds generally pursue or hold different investments, have different sets of investors and do not provide for cross-collateralization or cross-guarantees between funds. Because of this independence, we believe that any assessment of funds as a family would inappropriately aggregate data and result in a distorted and exaggerated representation of potential global systemic significance.

A private equity firm's investment in a sponsored fund is structured to limit the liability exposure of the firm, which exposure is generally restricted to a small ownership interest. Thus, private equity firms are not exposed to or otherwise connected to the fund-related risk transmission channels identified by the FSB and IOSCO.

Finally, the rationale supporting the assessment of an asset manager and its funds collectively – that a failure of one fund could cause a "run" on other affiliated funds – is inapplicable in the context of private equity funds, as such funds are not susceptible to runs because they do not permit redemptions in the ordinary course of business. Further, as noted by the FSB and IOSCO, such a risk is purely theoretical.

Q6-4. Should the methodology be designed to focus on whether particular activities or groups of activities pose systemic risks? If so, please explain the reason why and how such a methodology should be designed.

The PEGCC and EVCA believe that the Proposed Framework should be focused only on those activities that pose global systemic risks. To this end, the PEGCC and EVCA do not believe that either the long-term investments made by investors in private equity funds or the long-term investments made by the private equity funds in portfolio companies are the types of activities that create global systemic risks. Furthermore, as

noted above, investors in private equity funds (like all investment funds) accept the risks associated with such investments in order to receive a certain level of return.

Q6-5. Are the proposed indicators appropriate for assessing the relevant impact factors? If not, please provide alternative indicators and the reasons why such measures are more appropriate.

The PEGCC has supported an assessment methodology based on such indicators as size, substitutability, and interconnectedness in the past.[27] The PEGCC and EVCA continue to believe that application of such indicators as proposed by the FSB and IOSCO (*i.e.*, the sector-specific indicators for investment funds) are generally appropriate and demonstrate that private equity funds do not present global systemic risk concerns.

Although the PEGCC and EVCA believe that the application of the indicators in the Proposed Framework would conclude that private equity funds are not globally systemically important, the PEGCC and EVCA have concerns with respect to specific indicators as set forth in the comment letter and, in particular, with respect to the measurements of substitutability and cross-jurisdictional activities.

Q6-6. For "cross-jurisdictional activities", should "the fund's use of service providers in other jurisdictions (e.g. custody assets with service providers in jurisdictions other than where its primary regulator is based)" be used?

The PEGCC and EVCA do not believe that the fund's use of service providers in other jurisdictions should be used as a measurement of cross-jurisdictional activities. Private equity funds use service providers in limited circumstances and, as a general matter, view these service providers as highly substitutable. Private equity funds do not individually represent significant percentages of business for any service provider, which is itself of sufficient scale to have an impact on the financial system. Even with respect to the use of custodians, private equity funds are generally principally invested in private securities that are often uncertificated or otherwise not required to be maintained with a custodian because of their limited transferability.[28]

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[27] Comment Letter of the PEGCC on FSOC's Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (FSOC-2011-0001) (Feb. 25, 2011).

[28] Securities and Exchange Commission, Division of Investment Management, IM Guidance Update: Privately Offered Securities under the Investment Advisers Act Custody Rule (August 2013), available at http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf.

Q6-7. Is the definition of "net AUM" and "GNE" appropriate for assessing the "size" (indicators 1-1 and 1-2)?

With respect to investment funds, we believe that the NAV (or net AUM, as it is referred to in the Proposed Framework) is the appropriate measure of the amount that the fund might lose in the event of liquidation. However, the FSB and IOSCO should clarify that an investment fund's NAV does not include uncalled capital commitments, since these assets would not be at risk in the event of a liquidation of the fund.

Q6-8. Is the definition of "investment strategies" sufficiently clear for assessing the "substitutability" (indicator 3-3)?

The PEGCC and EVCA are concerned that the FSB and IOSCO have not provided sufficient detail on how to assess substitutability. As discussed in the comment letter, private equity funds compete for investors in private equity funds against a wide range of other investment vehicles and compete for investments in portfolio companies against a wide range of other investment vehicles and other market participants, including strategic partners.

Furthermore, the PEGCC and EVCA are concerned that Indicator 3-3 inappropriately captures all investment strategies, even where the strategies or the underlying assets are not themselves globally systemically important.

Q6-9. Would collecting or providing any of the information included in the indicators present any practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

As a primary matter, the PEGCC and EVCA believe that additional data reporting requirements should not be imposed on the private equity industry, since these indicators will not be assessed unless the investment fund exceeds the materiality threshold. In the United States and the European Union, private equity firms and funds are already subject to extensive information reporting, including on Form ADV and Form PF and under the Alternative Investment Fund Managers Directive (AIFMD). Since private equity funds are not globally systemically risky, the PEGCC and EVCA believe that any additional reporting requirements would simply impose additional costs and burdens on private equity firms and funds, including investors in private equity funds. Any additional reporting requirements that the FSB and IOSCO or the relevant national regulators consider proposing should be subject to a separate notice-and-comment period.

Q6-10. Are there additional indicators that should be considered for assessing the relevant impact factors? For example, should "the fund's dominance in a particular strategy (as measured by its percentage of net AUM as compared to the total AUM" also be considered for "substitutability"? Similarly, should "leverage" or "structure" of a fund also be considered for assessing "complexity"? Please explain the possible indicators and the reasons why they should be considered.

The PEGCC and EVCA have no specific suggestions on additional indicators that should be considered. As discussed in the comment letter, the PEGCC and EVCA have concerns with respect to the indicator regarding the dominance in a particular strategy and believes that the indicator should focus only in those situations where the underlying assets, directly or indirectly, relate to a critical function or service and the strategy represents a significant share of the holdings of the underlying asset. With respect to the inclusion of "leverage" and "structure" in the assessment of "complexity," the PEGCC and EVCA note that any such indicator would show that private equity funds are not globally systemically important. As discussed in several places in the comment letter, private equity funds do not generally incur significant leverage at the fund level. Furthermore, the structure of private equity funds and, in particular, the matching of long-term investors with long-term investments means that private equity funds do not present complex liquidations concerns.

Q6-11. Should certain indicators (or impact factors) be prioritised in assessing the systemic importance of investment funds? If so, please explain which indicator(s) and the reasons for prioritisation.

The PEGCC and EVCA believe that the FSB and IOSCO should take a balanced approach that does not place undue emphasis on any particular indicator, particularly the size of the fund. The PEGCC and EVCA do not believe that any of the indicators in isolation is sufficient to support a finding of global systemic importance. In fact, the absence of any of the categories of indicators would indicate that the fund is not globally systemically important. Finally, the PEGCC and EVCA are concerned that prioritization would be used as means to ignore counter-indicators with lower priority (*e.g.*, focusing on large fund even though it has no significant connections with counterparties in other jurisdictions).