The EU Benchmark Regulation and Private Market Investments

The EU BMR Regulation paves the way for a win-win case for both investors and General Partners, who can find in new compliant benchmarks, respectively, a tool for better and safer access to the asset class and the opportunity to broaden the market for their funds, to possibly include all retail investment savings and retirement solutions.

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Why 2022 can be a smart compliance, win-win turning point for investors and GPs.

Introduction

The private market industry has reached a multi-trillion dollars global dimension, and its growth prospects include the inclusive outreach towards every category of investor, progressively moving from the very sophisticated to the less sophisticated ones. The perceived success and attractiveness of the family of asset classes included in the industry, which encompass private equity, venture capital, private real estate, private debt, real assets, and infrastructure – all in their unlisted definition – is consequently initiating a process of progressive institutionalization, with increasing requirements of transparency from regulators.

The EU Benchmark Regulation (BMR – EU 2016/1011[1]) is one of the steps that the industry is going to adjust to. This new regulation enters into force on January 1, 2022 and EU-supervised users of indices, if such use falls within scope of the BMR, have an obligation to use only benchmarks that comply with the EU Benchmarks Regulation. As of the same date, EU users are prohibited from new use of existing non-EU indices and use of new non-EU indices (pending equivalence, endorsement, or recognition). At the same time, recently the BMR transitional period, as defined in BMR Article 51(5), has been extended to 31 December 2023. During the BMR transitional period, third country benchmarks, including UK ones, can still be used by supervised entities in the European Union if the benchmark is already used in the EU as a reference for financial instruments, financial contracts, or for measuring the performance of an investment fund.

Historically, it has been observed the proliferation of benchmarking tools for private equity that the Regulation will declassify, in most of the cases, to mere comparison statistics leaving current and prospective investors in the asset class segment without an underlying objective benchmarking reference, which is instead available for all other asset classes and is a critical element of transparency, product governance and investor protection.

Furthermore, the continued discussions on the topic of private equity performance are the sign that the dust is not settled on the topic. The benchmarking argument, in particular on private assets, rates high on the regulators' agenda, also outside the EU, with continued leadership by UK's FCA and increasing engagement by the U.S. SEC.

The 2022 deadline is an opportunity for improvement, creating a win-win case for both investors and General Partners (GPs), who can find in new compliant benchmarks, respectively, a tool for better and safer access to the asset class and the opportunity to broaden the market for their funds, to possibly include all retail investment savings and retirement solutions.

The EU Benchmark Regulation framework and objectives

The BMR is part of the EU's response to the LIBOR/EURIBOR rigging scandal. The EU Benchmark Regulation lays down a regulatory framework for indices used as benchmarks, which is designed to reduce the risk of benchmark manipulation and promote confidence in their accuracy and integrity and that of the financial markets which they underpin.

[1] https://www.esma.europa.eu/policy-rules/benchmarks

The Regulation implements and builds upon the global standards set out in the IOSCO Principles for Financial Benchmarks[2], which were published in July 2013.

The definition of "benchmark" for the purposes of the Regulation is extremely broad:

Any index by reference to which the amount payable under a financial instrument or a financial contract, or the value of a financial instrument, is determined, or an index that is used to measure the performance of an investment fund with the purpose of tracking the return of such index or of defining the asset allocation of a portfolio or of computing the performance fees.

With these objectives in focus, it introduces **a regime for the providers ("Benchmark Administrators") that ensures the accuracy and integrity of benchmarks**. Furthermore, the Benchmarks Regulation introduces a code of conduct for contributors of input data specifying contributors' responsibilities and requires the use of robust and reliable methodologies and sufficient and accurate data. In particular, it calls for the use of input data reflecting actual transaction data where possible. But other data may be used if the transaction data are insufficient.

Benchmarks Administrators have to apply for authorization / registration and are subject to supervision by the competent authority of the country in which they are located and are required to have in place appropriate governance arrangements and control frameworks to avoid conflicts of interest. The European Securities and Market Authority (ESMA) coordinates the supervision of Benchmark Administrators by national competent authorities.

When will an index be in scope of the EU Benchmarks Regulation and what will that imply?

Indices and Benchmarks are not equivalent notions, with the latter requiring the provision by a regulated entity, the Benchmark administrator, **on the basis of their intended use**.

The indices, defined in art. 3.1.(1) as *any figure (a) that is published or made available to the public, (b) that is regularly determined: (i) entirely or partially by the application of a formula or any other method of calculation, or by an assessment and (ii) on the basis of the value of one or more underlying assets or prices, including estimated prices, actual or estimated interest rates, quotes and committed quotes, or other values or surveys*, may fall within the scope of the benchmark regulation in the following circumstances:

Financial Instruments – It refers to those financial instruments that are within scope of MiFID II (transferrable securities), in relation to which a request for admission to trading has been made, or which is traded on an EU trading venue or EU Systematic Internaliser[3].
Financial Contract - Where the amount payable under an EU consumer credit agreement or EU residential mortgage agreement is determined by reference to a given index.
Investment Funds - Where a given index is used to measure the performance of certain investment funds (AIFs, therefore including PE and VC funds, or UCITS), with the purpose of tracking the return, defining the asset allocation of a portfolio, or computing performance fees. Typically, the location of the fund manager is the key variable to decide whether an index is in scope of the EU Benchmarks Regulation, since that is the entity "using" the benchmark within the meaning of the regulation. In light of the above, it would be possible to have a non-EU fund, with non-EU investors, managed by an EU manager, thus falling within the scope of the regulatory regime.

Regulation of a **benchmark is a statement of accuracy, representativeness, transparency and investor protection**. It affects both the methodology, the input data and the user group. As a result of the

[2] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf
[3] A systematic internaliser is an investment firm which, on an organised, frequent, systematic, and substantial basis, deals on own account by executing client orders outside a regulated market, an MTF, or an OTF without operating a multilateral system.

application of a rules-based, robust, and reliable methodology, which is rigorous, continuous and capable of validation, resilient, allowing calculation of the benchmark in the widest set of possible circumstances, the resulting benchmark should be reliable and representative of the market or economic reality that the benchmark is intended to measure.

Who is affected by the Regulation?

Article 29 of the Regulation states that **any EU supervised entity may use a benchmark or a combination of benchmarks only if it is provided by a regulated administrator**. Broadly speaking, the term "supervised entity" is defined to cover regulated financial service providers, including:

- credit institutions
- investment firms
- insurance and reinsurance undertakings
- UCITS or, where applicable, UCITS management companies
- alternative investment fund managers (AIFM)
- institutions for occupational retirement provision (IORPs)
- creditors, within the meaning of the Consumer Credit Directive
- non-credit institutions under the Mortgage Credit Directive
- Central Counterparty Clearing (CCP)
- trade repositories
- administrator

Any undertaking that manages a Private Equity or Venture Capital fund is classified as supervised entity under the BMR regulation in that it comes within the scope of the AIFM directive to the extent the fund it manages meets the directive's definition of an AIF. The directive requires that every AIF has a single fund manager to manage the fund.

Given its far reaching scope that affects every supervised financial institution in the EU, the Regulation has, in substance, both a **direct impact on every non-EU entity interacting with EU supervised entities and an indirect impact on every other entity competing internationally in the financial industry**, because of the higher standards imposed on Benchmarks in the EU.

The UK FCA, originally a driving force behind the BMR, in the policy statements of its recent Asset Management Market Study[4] reinforces the requirements for consistency and appropriateness of benchmarks.

Among other matters, "*the new rules and guidance require fund managers to explain why or how their funds use particular benchmarks or, if they do not use a benchmark, how investors should assess the performance of a fund*". The new rules apply to "*UK authorised fund managers (in respect of their management of authorised funds) and will also interest others in the investment management industry, including delegated portfolio managers, depositaries of authorised funds, and retail and professional investors, including advisers"*.

In the U.S. the SEC has formed in late 2019 its Asset Management Advisory Committee (AMAC)[5] to provide the SEC with *(a) diverse perspectives on asset management, including (i) trends and developments affecting investors and market participants, (ii) the effects of globalization, including as it relates to operations, risks and regulation, and (iii) changes in the role of technology and service providers, as well as with (b) related advice and recommendations*. The AMAC has formed a Private Investments Subcommittee, which currently

[4] https://www.fca.org.uk/publications/policy-statements/ps19-4-asset-management-market-study-feedback-cp18-9-final-rules-guidance

[5] https://www.sec.gov/page/asset-management-advisory-committee

debates and focuses on potential expansion of access to private investments. In its Dec. 1, 2020 meeting the Subcommittee addressed the challenges in measuring private equity returns and benchmarking and how private equity returns compare to public market returns.

Are there any benchmarks for Private Market Investments?

The definition set by the Benchmark Regulation allows a more precise classification.

There are **several so-called benchmarks, that, as of January 2022, will need to be reclassified as mere indices or peer group statistics**, in particular with reference to unlisted private market instruments.

Very often, in the private equity space, the term 'benchmarks' is used in a broader sense to include statistical analyses and ratios that are constructed to allow intra and cross-asset class comparisons of various performance metrics. This is the case of certain ratios or metrics, like the so-called Public Market Equivalent or Alpha measures[6], or the most traditionally referenced quartiles of IRRs.

In many instances, these measures are derived from pro-forma calculations that neglect mathematical and statistical accuracy. This is the case of, for example, quartiles, averages or annualised measures of IRRs. The limitations of these measure are normally recognized by the same proponents that include footnotes that warn of the non-comparability of the results displayed with public market benchmarks.

There are instead **a few indices relating to listed private markets that, instead, would correctly fall in the Benchmark Regulation definition**, since they all represent the economic reality of listed shares of private market-related vehicles. This is the case of the first group of indices in the following list:

	Index Name	Ticker Refinitiv	Publication frequency	Index Constituents	Performance Metrics
	LISTED Indices				
1	**LPX Buyout Listed Private Equity Index TR**	.LPXBOTR	Daily	Listed PE	Returns are calculated using stock market returns
2	**LPX America Listed Private Equity Index TR**	.LPXAMTR	Daily	Listed PE	Returns are calculated using stock market returns
3	**LPX Composite Listed Private Equity Index TR**	.LPXCMTR	Daily	Listed PE	Returns are calculated using stock market returns
4	**Red Rocks Gbl Listed Private Equity TR USD**	GLPEXUTR	Daily	Listed PE	Returns are calculated using stock market returns
5	**S&P Listed Private Equity Index**	.SPLPEQNT	Daily	Listed PE	Returns are calculated using stock market returns
6	**SG Private Equity Index (PRIVEX) USD TR**	.PRIVEXD	Daily	Listed PE	Returns are calculated using stock market returns
7	**Thomson Reuters Private Equity Buyout Index**	.TRPEI	Daily	Listed PE	Value-weighted index of stock market returns
	UNLISTED Indices				
1	**Burgiss Index Manager Universe**		Quarterly	Unlisted PE	Modified Dietz time-weighted rate of return
2	**Cambridge Associates U.S. Private Equity Index**		Quarterly	Unlisted PE	Pooled Horizon Internal Rates of Return (IRRs), net
3	**CEPRES Buyout Index**		Quarterly	Unlisted PE	Horizon Internal Rates of Return (IRRs)
4	**Cobalt/Bison Private Equity Benchmark**		Quarterly	Unlisted PE	Bison-customised Public Market Equivalent (PME)
5	**ILPA (Institutional Limited Partners Association) U.S./CAN Private Equity Index** **ILPA (Institutional Limited Partners Association) Europe PE & VC Index** **ILPA (Institutional Limited Partners Association) Asia/Pacific PE & VC Index**		Quarterly	Unlisted PE	Pooled Internal Rates of Return (IRRs)
6	**Private Equity Quarterly Index – PrEQIn**		Quarterly	Unlisted PE	Percentage change in NAVs, taking into account capital calls and capital distributions
7	**PitchBook Private Equity Benchmarks**		Quarterly	Unlisted PE	Percentage change in NAVs, taking into account capital calls and capital distributions
8	**State Street GX Private Equity Index**	.GXPEI	Quarterly	Unlisted PE	Since inception Internal Rates of Return (IRRs)

Conversely, the second group of indices above is of unlikely recognition as 'usable' regulated benchmarks.

What it takes to Private Market indices to become benchmarks?

The Regulation leaves ample flexibility for the construction of Benchmark indices if they fall within the framework that it defines. As stated above, **what drives the Benchmark Regulation is the definition of the 'use' of the indices coupled with the 'statement of accuracy and representativeness of the market or economic reality'** discussed earlier.

[6] https://www.insead.edu/sites/default/files/assets/dept/centres/gpei/docs/Measuring_PE_Fund-Performance-2019.pdf

The limitation that would then emerge is that, **for asset allocation purposes, the above-mentioned unlisted indices would not fit any requirement of accurate comparison with any of the traditional asset classes' benchmarks**, which are constructed according to the accepted best practices for the construction of indices and in a time-weighted fashion (in contrast with their prevalent money-weighting construction).

The CFA Institute has published its guidelines[7] for a benchmark to be credible and useful to investors:

"Such benchmark must fairly and accurately represent the key attributes of the market segment or financial instrument in question. In particular, benchmarks should be investable, measurable (with some frequency for performance attribution), appropriate, reflective of current investment opinions, specified in advance (publicly known at the start of an evaluation period where possible), and owned (i.e., there is appropriate accountability)."

Most of, if not all, the above unlisted benchmarks would not respect these guidelines – also taking into account the fact that these guidelines offer ample margin for interpretation.

Asset allocation exercises and investment solutions imply multi-temporal[8] considerations that are hardly compatible with money-weighted rates of returns, which are atemporal by construction and imply unrealistic reinvestment or refinancing assumptions. Money-weighted rates of returns as performance measurement metrics are incompatible with the requirements of regulated benchmarks.

The private market economic reality that benchmarks aim to represent

The current benchmarking narrative falls back to the Public Market Equivalent (PME) approach, that compares public and private market investments hypothesizing the investment in a listed market benchmark of the cash flows of a private equity fund, irrespective of the facts that:

1. it can lead to financing shortfalls of the fund's commitment (leading to LP obligations' defaults);
2. the exercise is properly performed on single-asset basis and its results are hardly comparable, less so properly averaged.

Nevertheless, its many supporters justify its adoption based on the apparent ability of the (PME) to detect the actual ability of the GP to deliver a risk premium and beat or not the selected equity benchmark.

However, **does PME represent the market or economic reality[9] of private market investments** for Limited Partners (LPs) and GPs?

An interesting and objective evidence of the economic reality of private market investments for LPs and GPs can be found in an academic study led by one of the most recognized proponents of PME, co-developer of its most adopted version. A surprising result emerges immediately from the paper's abstract:

*"We survey 79 private equity (PE) investors with combined assets under management of more than $750 billion about their practices in firm valuation, capital structure, governance, and value creation. **Investors rely primarily on internal rates of return and multiples to evaluate investments. Their limited partners focus more on absolute performance** as opposed to risk-adjusted returns."*

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[7] Benchmark and Indices – Issue Brief, CFA Institute (April 2013) https://www.cfasociety.org/france/Documents/Advocacy/Benchmarks%20and%20Indices%20Issue%20Brief%20(Apr%202013)%20(final).pdf

[8] https://www.cfainstitute.org/-/media/documents/protected/refresher-reading/2021/pdf/overview-asset-allocation.ashx

[9] Gompers, Paul A. and Kaplan, Steven Neil and Mukharlyamov, Vladimir, What Do Private Equity Firms Say They Do? (June 1, 2016). Journal of Financial Economics (JFE), Vol. 121, No. 3, 2016, Available at SSRN: https://ssrn.com/abstract=2447605 or http://dx.doi.org/10.2139/ssrn.2447605

The evidence contradicts the authors' expectations of support for the PME, to an extent that the authors feel that they have to restate their rationale for the PME case.

"*This is also puzzling given that private equity investments are equity investments, some of which had been publicly traded prior to a leveraged buyout. Such investments carry significant equity risk, suggesting that equity-based benchmarks such as public market equivalents (PMEs) are appropriate.*"

In fact, the PME is a measure of relative performance that does not captures the full dynamics of a private market investment either from GPs' perspective, who do not set their targets in terms of relative performance versus a listed benchmark, or from **LPs' one, who have not found a consensus on the appropriate private market benchmarks to consider, given the current debate on PE risk-adjusted returns**. Just like IRR, PME does not allow proper additivity and statistical treatment. Furthermore, LPs are seemingly not interested at any "closet indexing" features that the PME, measuring the wealth multiple effect of investing in the PE fund versus the index, appears to test at fund level.

Among the reasons of the LPs's unsatisfactory situation are a few elements that rates high on their priority list: not only PME, like all other traditional metrics and unlisted does not allow proper multi-asset comparability but also it fails to properly incorporate the impact of the dry powder and of the subscription and other credit facilities that have a conflicting impact of IRR, multiples and capital efficiency.

The regulatory assist for the way forward

IRR has clearly a relevant space in GPs' investment approach as a yardstick, together with multiples, in particular, at portfolio level. The problem with IRR arises from LPs' perspective, which should incorporate how much capital, when and for how long the capital itself is invested. However, IRR is atemporal and only relevant for a point in time and cannot be accurately averaged, delivering an inaccurate synthesis of portfolio's performance. Furthermore, compounding (as computed with geometric means) implies asset realization and reinvestment assumption. Here is where, for IRR, the chickens have come home to roost. In fact, one of the major flaws of IRR is its reinvestment assumption, i.e., the fact that capital distributed to LPs early on will be reinvested over the life of the PE fund at the same IRR as calculated at the early exit. All these problems extend to all currently used metrics, all somehow related to IRR.

What is clear is that **investors need better benchmarks that can assist them in a more accurate representation of private market investments' risk-return profile in their asset allocation**. The direction marked by the Regulation is also clear, i.e., to represent accurately and reliably the economic reality of private market investments that the benchmark is intended to measure.

The objective is to connect GPs' practices to LPs's needs in a way that is compatible with the capital market standards of representativeness, integrity, and reliability. Such characteristics do define what it is to be an index that aims to measure the same return of the portfolio of its actual constituents, following a set of transparent rules defined ex ante and without altering the risk-return profile of the underlying.

XTAL Private Market Benchmarks

Private equity, as the term evokes, involves investments of equity capital in private businesses. Private equity is, indeed, a stake in a private company. Generally speaking, private equity refers to a leveraged acquisition/buyout of a large interest in a mature, cash-flow-stable company. Earlier stage investments are usually labelled as venture capital.

Investors usually access private equity investments through closed-end funds set up by GPs through Limited Partnership Agreements (LPAs).

Limited partnerships have a fixed lifespan (usual 10 years) and are self-liquidating. In the first 5-year (investment period) GPs have the right to call tranches of the capital committed by the investors, LPs, to purchase private equity stakes. In the second 5 years (liquidation period) the stakes are sold, and capital and net gains are returned to LPs. Upon LPs' approval, the fund life can be extended to facilitate liquidation.

Initially, XTAL Private Market Benchmarks encompass the fund stage focus of Buyout funds, i.e., funds that acquire companies by purchasing majority or controlling stakes and financing the transaction through a mix of equity and debt.

XTAL Private Market Benchmarks accurately track and measure the performance of unlisted buyout funds. They represent, and are conducive to, physical allocation to the constituent buyout funds, with no proxy assets inclusion or algo replication. XTAL Private Market Benchmarks are either size-weighted, i.e., they are committed capital-weighted indices, or equal-weighted, i.e., every private equity vehicle has the same weight in the index, and a portfolio that tracks the index is expected to invest an equal dollar amount in each underlying constituent. As private equity valuations change, the weights of the index constituents will change, and exact equality will be lost. However, differently from an equal-weighted index that must be rebalanced from time to time to re-establish the proper weighting of the index constituents, XTAL Private Market equal-weighted Benchmarks are not rebalanced to fully reflect investors experience that usually access private equity investments via closed-end funds set up by GPs through Limited Partnership Agreements. Similarly, XTAL Private Market size-weighted Benchmarks require no rebalancing if there are no changes to share counts, returns of draw down capital (capital call), or constituents' addition or deletion.

The XTAL Private Market Benchmarks are clustered and calculated by vintage year. Vintage year is defined as the legal inception date of the private equity fund. This date is usually found in the first note to the audited financial statements and is prior to the first close or capital call.

The XTAL Private Market Benchmarks are rules-based and calculated according to a modification of the original Laspeyres index formula[10] and builds upon the groundbreaking and patented methodology of DaRC[11] (Duration-adjusted Return on Capital). DaRC is based on a fixed income calculation framework and computes private equity returns in the same time-weighted fashion of any other asset class, thus making unbiased pricing, proper benchmarking, and risk transfer in private markets possible.

The XTAL Private Market Benchmarks are computed and disseminated daily at the end of the index calculation period.

The input cash flows (contributions and distributions) and net asset values data used to process private equity valuations and calculate the XTAL Private Market Benchmarks are the same data that are delivered to actual investors, possibly via a regulated third-party custodian or depositary bank, or published in the quarterly unaudited and annual audited fund financial statements produced by the GPs for their LPs. XTAL does not use regulatory filings, Freedom of Information Act (FOIA) requests, manager surveys, or press "scrapings" to obtain information. XTAL maintains a complete historical record of the cash flows and quarterly net asset values for all buyout funds in the indices. XTAL uses a number of paths to encourage GPs to submit the relevant data to the XTAL Private Market Benchmarks database.

[10] https://ec.europa.eu/eurostat/statistics-explained/index.php/Glossary:Laspeyres_price_index

[11] US 8,386,356 B2 and related PCT applications