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Invested in a better future

James Risk
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HM Treasury
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By email: ringfencing_review@hmtreasury.gov.uk

18 December 2023

Dear James

Re: A smarter ring-fencing regime

The BVCA is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of around 620 firms, we represent the vast majority of all UK based private capital firms, as well as their professional advisers and investors. In 2022, £27.5bn was invested by private capital into UK businesses in sectors across the UK economy, ranging from consumer products to emerging technology. There are over 12,000 UK companies backed by private capital which currently employ over 2.2 million people in the UK. Over 55% of the businesses backed are outside of London and 90% of the businesses receiving investment are SMEs.

The BVCA welcomes the policy objective of HMT's proposals to give ring-fenced bodies (RFBs) greater flexibility to support UK SMEs, including through investment in private equity and venture capital (private capital) funds. Private capital funds are an important source of capital and support for UK companies, especially SMEs. We have set out below a number of points which we consider would enhance HMT's proposals and serve to promote the Government's policy goal of facilitating investment and supporting UK SMEs.

Investment policy

The requirement for an SME investment fund to have a policy of investing at least 70% of its investment capital in UK SMEs may be too restrictive. Permitting a lower level of target UK SME investment may increase the number of funds into which RFBs can invest, which in turn would likely increase the amount of investment in UK SMEs. However, a requirement to prescribe any level of UK SME investment in an investment policy may still be too restrictive to facilitate meaningful investment by RFBs in UK SMEs through private capital funds.

This is because the investment policy of most private capital funds investing in SMEs will not typically restrict investment to the UK. For private capital fund allocations, as with any portfolio of investments, it is usually important to the fund's investor base (typically composed of a range of global institutional investors) that the fund's investment policy permits and even sometimes requires diversification across a range of industries and markets, to avoid undue risk concentration and enhance overall returns. The investment policy must also remain sufficiently flexible to enable fund managers to adapt to changing market conditions. Diversification across jurisdictions is therefore usually permitted and often enshrined in the contractual provisions establishing a fund, which will often seek to restrict the fund manager from investing more than a certain proportion of the fund's capital commitments into any one geography (or asset or sector).

Given that any RFB seeking to invest in a private capital fund would likely be one investor amongst a pool of international institutional investors, and that those other investors will typically all demand an investment policy with sufficient flexibility to ensure diversification of the fund's assets, we are

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concerned that a requirement for RFBs only to invest in funds that are required to invest 70% of their capital in UK SMEs would effectively shut RFBs out of the market. Such funds will be rare and it seems unlikely that RFB demand alone would change this, particularly as it is also commercially sensible for a fund manager to seek diversification amongst its funds' investor base (as well as amongst its funds' assets).

Despite the need for diversification and the typical absence of investment policy restrictions for a fund to invest in UK SMEs, UK-managed private capital funds do nevertheless invest significant amounts in the UK economy - private capital backed businesses directly generated around £137bn of GDP in 2023 (equivalent to 6% of the UK's total GDP), and there is a clear domestic bias amongst UK managed funds, which invest around 50% of the international capital they raise into UK businesses. We believe a key reason for this disproportionately high level of investment in UK SMEs by UK-managed private capital firms is that investing in smaller, unlisted businesses depends very heavily on deep knowledge of local markets and requires private capital firms to develop strong personal relationships with portfolio company management teams. Naturally, this close working relationship is facilitated when a UK-based private capital firm is working with a UK-based portfolio company.

Therefore, we suggest the requirement for an SME investment fund to have a policy of investing at least 70% of its investment capital in UK SMEs is too restrictive and should be removed. We recommend RFBs should instead be permitted to invest in any AIF with an investment policy to invest predominantly in SMEs that is managed by a UK AIFM (or a third country AIFM which has appointed a UK authorised firm as its delegate or subadvisor (see below)). The requirement for there to be a UK-authorised firm managing or advising on the portfolio of the fund should be sufficient to increase the amount of investment in UK SMEs.

In the alternative, if some kind of geographic restriction is required, we suggest the Government consider whether the restriction could be expanded to require that 70% of a fund's capital be invested in the UK or EEA. We note that the 70% proposal mirrors the rules for the EuVECA label, which is only available to funds that invest 70% in the EEA and which has proven a reasonably popular fund product in the EEA (and in the UK, pre-Brexit). We think the reason this restriction works in an EEA context is that a significantly greater degree of investment diversification can be achieved by investing across the multiple national markets that constitute the EEA, than can be achieved by investing only in the UK. Coupled with the UK domestic investment bias referred to above, we suggest that this would be enough to satisfy the policy objective of increasing RFB investment in UK SMEs

AIFs managed by UK AIFMs

To qualify as an SME investment fund, the proposal also says the fund must be managed by a UK AIFM. We understand the reason for this proposal, given the policy objective, but wish to highlight a nuance of typical private capital fund structures that means this proposal will limit the number of funds qualifying as SME investment funds.

A single private capital fund structure typically consists of various entities that are often based in different jurisdictions, largely in order to facilitate fundraising into a single fund product from different types of institutional investor in different jurisdictions around the world.

Partly in order to facilitate access to EEA investors following Brexit, many UK-based private capital firms managing funds that invest in UK SMEs, despite maintaining the bulk of their activities in the UK, now locate their AIFM entity in an EEA jurisdiction, such as Luxembourg or Ireland, rather than in the UK. These firms typically now conduct their UK-regulated activities not as UK AIFMs but as UK MiFID firms which act as delegates or sub-advisers to an AIFM outside the UK. These arrangements are very common in private capital and enable the third country AIFM to benefit from the expertise and resources of the UK-based adviser / arrangers.

We recommend that this reality be reflected by providing that an AIF should qualify as an SME investment fund where the fund is managed by a (1) UK AIFM or a (2) third country AIFM which has appointed a UK authorised firm as its delegate or sub-advisor.

If there is a concern that permitting investment by RFBs in funds managed by non-UK AIFMs would expose RFBs to non-UK risk, we do not think this should be a significant concern because the risk is limited by the cap on all permitted SME investments of 10% of tier 1 capital (Article 7A).

Calculation of percentages

We think it would be helpful to clarify how certain of the thresholds operate. An SME investment fund cannot 'at any time' invest more than 30% of its investment capital in enterprises that are not UK SMEs. It is not clear whether, for the purpose of this calculation, the value attributed to the investments of the fund should be the acquisition value or the current valuation. If it is the current valuation there is a risk that an investment fund may breach the threshold solely as a result of the relative performance of its investments (where investments which are not UK SMEs increase in value relative to the UK SMEs).

This may not matter if it is clear that an RFB does not carry on an excluded activity solely by retaining an investment in, or honouring an existing capital commitment to, an investment fund which, at the time of the initial investment or commitment, qualified as an SME investment fund. We consider this should be the proper interpretation of Article 7A(1)(b) since it provides that an RFB does not carry on an excluded activity by 'entering into a transaction to…(b) invest money in an SME investment fund by acquiring an interest in that SME investment fund'. However, we think it may be clearer if the wording 'by acquiring an interest in' were deleted. An investor will not acquire an interest in an investment fund until their committed capital is actually called. Deleting the reference to the acquisition of an interest in the fund would address the risk that an RFB may have made a capital commitment to an investment fund which at the time of the commitment was an SME investment fund, but due to movements in the value of its investments it had ceased to be one by the time the RFB was required to honour its commitment.

Please let us know if you have any questions and we would welcome an opportunity to discuss this in more detail with you. Please contact Tom Taylor ttaylor@bvca.co.uk / Nick Chipperfield nchipperfield@bvca.co.uk).

Yours sincerely,

Tim Lewis
Chair, BVCA Regulatory Committee