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Environmental, Social and Governance (ESG) Division
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Dear FCA ESG Division

BVCA response to FCA Discussion Paper 23/1: Finance for positive sustainable change: governance, incentives and competence in regulated firms

The BVCA is the industry body and public policy advocate for the private equity and venture capital ("private capital") industry in the UK. With a membership of over 750 firms, we represent the vast majority of all UK-based private capital firms, as well as their professional advisers and investors. Between 2017 and 2021, BVCA members invested over £57bn into around 3,900 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private capital currently employ over two million people in the UK and 90% of the businesses our members invest in are small and medium-sized businesses.

Given the nature of DP 23/1, we have set out our response in a narrative thematic format rather than answering specific questions. We set out a summary of the key points below:

- We welcome the FCA's engagement with the industry on the continuing development of sustainability related regulation in the UK.

- Many firms within the UK private capital industry already embed consideration of "sustainability-related risks" and into their existing investment and capital allocation decisions as well as their risk management processes. As noted below, many private capital firms also consider sustainability related opportunities when making investment decisions or as part of the development of new products.

- We believe that it is vital that the FCA recognises the diversity of approaches within the international financial markets and the private capital industry. In this regard, we believe that it is important that firms should be free to set and pursue their own sustainability related goals and objectives. Other than in relation to some basic investor protection measures, we believe that the FCA's focus in this area should be on ensuring that firms have the ability to keep the sustainability-related commitments that they make to investors and other stakeholders, rather than to dictate what those commitments ought to be.

- We welcome the FCA's focus on proportionality and further expand on the ways in which a firm's size, sophistication and complexity interact with their approach to sustainability below.

- In general, subject to our comments below, we do not believe that there is a need for further specific regulation or rules in relation to governance, incentives and competence relating to sustainability given the relatively early stage of the evolution of the sustainability landscape for private capital. We do see some potential value in the introduction of high-level requirements or clarificatory guidance, to the extent this does not already exist.

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The FCA's engagement and flexibility are welcome

We welcome the FCA's early, ongoing and considered engagement with industry on the evolution of UK sustainability regulation, both in this discussion paper and more broadly. This approach is vitally important because the commercial, scientific and global policy contexts that are driving sustainability considerations in financial services and the wider economy continue to develop rapidly. This complexity and dynamism mean that both firms and the regulator are operating under a shifting pattern of different and potentially competing influences, which needs to be reflected in dynamic and flexible regulation. Providing effective regulatory support for positive sustainable change in this context is an ambitious goal in itself, and we firmly believe the FCA's collaborative approach to sustainability regulation is the right way to go about delivering that.

Integration of sustainability considerations is "simply good business"

We welcome the FCA's recognition that many firms already embed "sustainability-related risks… into their business, risk and capital allocation decisions" having concluded that this is "simply good business". We would add that, in private markets, sustainability opportunities are also routinely considered in the development of new products as well as in investment decisions in products that are not specifically focused on sustainability. Consumer demand, investor sentiment and firm culture have been the key drivers of various industry initiatives aimed at helping private capital firms to integrate such sustainability considerations into their businesses. Examples of these include the following (this is just a sample, there are many more):

a) Initiative Climat International (iCI), a global community of over 200 private equity firms supported by the UN Principles for Responsible Investment and the BVCA and representing over US$3.4 trillion in AUM. iCI was established in the wake of the Paris Agreement by private capital firms seeking to further understand and manage the risks associated with climate change, reduce carbon emissions of private equity-backed companies and secure sustainable investment performance by incorporating the materiality of climate risk.

b) The Private Equity Sustainable Markets Initiative Taskforce, which consists of numerous global private equity firms and, like iCI, shares best practice and develops tools to assist the industry in approaching technical challenges related to its role in the transition to a low carbon economy (e.g. carbon pricing), embedding biodiversity considerations and developing effective ESG metrics.

c) Various Diversity & Inclusion initiatives, such as Level20 and the BVCA's 'Guidance and Best Practice examples for VCs, Private Equity and Institutional Investors' (produced by leading private capital firms and focusses on increasing investment in underrepresented founders and driving diversity and returns across the sector). Our 2023 report on diversity and inclusion in the sector is available on our website.

d) ImpactVC, a community of venture firms working to accelerate impact within venture by developing knowledge, tools and resources.

We believe it is very important that any further regulatory developments in this area recognise such existing industry-led progress and supports the steps firms have already taken to integrate sustainability considerations across their operations rather than seeking to impose additional rules or prescriptive standards.

Integrating sustainability considerations is a business imperative for private capital

The appropriate consideration of sustainability risk and, in appropriate cases, opportunity is a business imperative for private capital firms. Our members typically deploy institutional investors' capital into unlisted companies over which they acquire significant influence or control for a period of three-to-seven years prior to exit. The industry's value creation model depends on the private capital firm working with the investee

companies during that extended holding period to increase the value of those companies, so that they are more valuable – and attractive to potential buyers – at the time of ultimate exit.

A firm's failure to consider material sustainability risks and opportunities during that period would likely reduce rather than increase the price for which a portfolio company can be sold on exit. This would happen either directly, because certain sustainability risks may have materialised during the holding period, or indirectly, because potential buyers three-to-seven years hence will potentially be even more focussed on strong corporate sustainability credentials than they are now. Private capital firms' commercial success depends on the level of returns their funds generate for their investors from successful exits, and so firms are subject to powerful commercial incentives to integrate the consideration of sustainability risks that could affect the success of those exits.

In addition to this commercial imperative, we also feel it is right from a regulatory perspective that firms managing investors' capital be required to take account of material financial risks of any nature, which evidently includes risks that may arise from sustainability-related factors. We think firms are already largely required to do this under current UK regulation.

We would like to refer the FCA to the approach the EU has taken recently to require the integration of sustainability risks under the level two measures in respect of the UCITS Directive, AIFMD and MiFID II, whereby the EU has made limited and targeted changes to the relevant legislation to impose requirements on firms to "take into account" sustainability risks in areas such as their organisational arrangements, processes, resources and conflict management (including in relation to remuneration). For the most part, we consider such high-level changes to be proportionate in the context of EU sustainability regulation, although we do not think they are strictly necessary for the UK given the FCA's existing, more general, rules on such matters.

Sustainability opportunities and impact

Although consideration of material sustainability risks may be of more general application to investment decisions, whether or not the thesis for a particular investment product or, indeed, underlying investment should use either sustainability factors or impact potential as lenses to inform investment decisions (i.e. as part of its investment strategy) is and should remain the choice of the firm that designs, markets and manages the product. We believe the role of regulation here is to ensure that firms holding out their products as having particular sustainability credentials are able to support those claims with appropriate governance, processes, resources, competency and so forth. Put simply, we believe regulation should not direct firms or products to have a sustainable purpose, rather it should aim, at a high level, to ensure that firms claiming that they or their products have such a purpose are appropriately positioned to deliver it for their investors.

We support the FCA's focus on proportionality

We fully support the FCA's commitment to considering proportionality. An effective method of "differentiation between firms on the basis of size (or other characteristics)" will be necessary for any further sustainability regulation to succeed in supporting the private capital industry's contribution to positive sustainable change in the real economy whilst maintaining UK competitiveness and furthering the Government's net zero ambitions. We also wish to highlight that private capital AIFs are typically bespoke institutional products, whose terms are negotiated between firms and highly sophisticated institutional investors, which again points to the need for flexibility and proportionality in any additional investor protection requirements focused on sustainability. We have expanded below, where relevant, on why proportionality is necessary in any regulation relating to governance, incentives and competence.

The governance of sustainability in private capital

We consider effective governance, appropriate accountability and clear 'ownership' of a firm's sustainability strategy and its implementation to be important drivers of the sustainability performance of a firm and its products. Private capital legal and governance structures vary significantly from firm to firm but are typically

more complex than those of publicly listed companies. Whereas the board of a public company has oversight of strategy and risk management, such responsibilities within a private capital firm are more likely to be shouldered within different governance bodies, established variously under corporate and partnership law, in different firms (partnership boards, investment committees, management teams etc.) and will often also include a cross-border component (for example, a regulated private capital firm in the UK (where sustainability regulation is more developed), may report into a parent entity based in the United States (where sustainability regulation is arguably in an earlier stage of development) or the EU (where sustainability regulation is advanced but evolving differently).

This variety in structures and applicable regulation calls for a case-by-case approach to determining at what level the appropriate sustainability-related governance responsibilities should apply, which in turn means that any further UK regulatory requirements should remain high-level, flexible and principles-based, rather than prescriptive. We also note that industry guidance on integrating sustainability considerations into private capital governance structures already exists. For example the UN Principles for Responsible Investment (PRI) has published a suggested governance structure to help private capital firms identify, manage and oversee climate-related risks, opportunities and impacts (which is supplemented by the BVCA/iCI guide to TCFD reporting for private equity, for firms implementing TCFD-based systems and processes).

Regulatory proportionality and flexibility are important in a sustainability governance context because governance structures amongst private capital firms are also likely to differ from firm to firm, and from fund to fund, based on factors such as a firm's size and its funds' investment strategies:

a) Size: Private capital firms of various sizes will typically allocate responsibility for sustainability considerations to senior management as a whole and include sustainability issues on the agenda of the relevant governance body. Larger firms will have greater capacity to assess and manage sustainability risks and assign dedicated responsibility potentially to the head of larger dedicated sustainability teams. The majority of BVCA members in number are smaller firms, often led by a handful of partners, which may allocate responsibility for sustainability either as part of a broader role or to the senior management as a whole. Where this is the case, firms will often assign responsibility for sustainability considerations to individuals whose other responsibilities are close to the core functions of the business, such as the Chief Operating Officer or Chief Investment Officer. This reflects the view of many firms that integration of sustainability considerations is "simply good business" and so should be considered by the COO or CIO in any event as part of their role.

b) Investment strategies: One firm will also differ from the next in respect of the materiality or relevance of sustainability considerations to the investment strategy of its funds. For example, a firm investing in software companies might require a different emphasis on sustainability in the governance structure of the firm and its funds to another that invests in heavy industry, because climate or other sustainability considerations may present less material financial risks in the software context. Similarly, for firms managing funds with an impact investment strategy, more detailed consideration of the governance of sustainability risk, opportunity and impact is likely to be appropriate than in the case of a firm focussing on more general investment strategies.

This variety in size, resource and investment strategy, as well as pointing to a principles-based approach, underlines the need for any further regulatory obligations to be subject to proportionality. As suggested above, we do not think it is necessary to include specific new rules that go beyond those that already exist and those proposed by CP 22/20 (SDR). However, if any further general rules are envisaged, we re-iterate that the regulatory framework must continue to reflect a variety of decision-making structures and sustainability strategies or claims – and, in particular, reflect the specificities of private markets.

More specifically, we note the FCA is considering in particular whether the SMCR regime should be supplemented by requiring firms to assign responsibility for the delivery of sustainability-related strategies or transition plans. Most private capital firms are Core Firms under SMCR, and as such are required to apply a more limited and proportionate set of SMFs, relative to Enhanced Firms. We agree that firms should consider which SMF(s) is/are responsible for sustainability strategy and transition, but we think the current rules for Core Firms offer a sufficient and proportionate framework for ascribing such responsibility, and that a specific new SMF for sustainability considerations would create an imbalance of emphasis in relation to the existing list of required functions.

Existing and incoming sustainability-related product governance rules

We also note that extensive sustainability-related governance reporting requirements are already in place for products and firms subject to regulatory TCFD-based reporting, that the FCA is proposing to introduce a new "anti-greenwashing" rule (although existing rules already require disclosures to be "clear, fair and not misleading"), and that the FCA has indicated that the overarching qualifying criteria for use of the fund labels proposed for the SDR regime are likely to include requirements for firms to maintain sufficient governance structures for labelled products (proposed Principle 4). We understand the SDR requirements are intended to apply to labelled products only and, to some extent, those which include sustainability-related features that are integral to their investment strategy. We therefore encourage the FCA to consider fully, and in a sequenced manner, the extent to which any more general regulatory requirements might be required, how they might interact with and complement the SDR labelling rules when finalised, and how duplication can be avoided in relation to the existing TCFD-based framework.

Incentives and remuneration

Carried interest is a distinctive incentive model

Incentive and remuneration arrangements in the private capital industry are relatively complex and varied, but almost always based around the long-term carried interest model, which is well-suited (and therefore almost universally adopted) for illiquid investment strategies focussed on taking significant stakes in unlisted companies primarily in order to generate long-term capital growth. Carried interest is fundamentally different to shorter-term incentive and remuneration arrangements (such as bonuses) used by regulated firms investing in more liquid or income-generating asset classes. This is principally because it is based on realised returns from capital growth in unlisted equity, typically only starts to be received by firm executives towards the end of the life of a fund (private capital funds are predominantly closed-ended) and is usually only awarded if realised returns from the fund's portfolio companies in aggregate are successful enough to generate a profit for investors above a hurdle rate (typically 8%).

These distinctive features are already recognised in other UK regulatory, tax and legal frameworks, such as IFPR (which disapplies certain pay out process rules for carried interest) and AIFMD (where the FCA applies the principle of proportionality to deem carried interest arrangement compliant with the framework's remuneration rules). We think, more broadly, that the introduction of regulatory requirements linking remuneration to sustainability targets should be considered with extreme caution, as they will not necessarily have the desired effect, but nonetheless urge the FCA to recognise from the outset that carried interest requires distinctive treatment in any regulatory context.

Private capital executives are already incentivised to maximise the sustainability performance of investments

The distinctive features of carried interest also make it an effective method of aligning the interests of investors with those of the key executives of the private capital firm who are responsible for driving the growth of portfolio companies and exiting them at a profit. As explained above, there is an existing commercial imperative for private capital firms to integrate material sustainability considerations into their investment and value creation processes, because companies with stronger sustainability credentials attract higher exit prices, and higher exit prices mean higher returns for investors, which means higher carried interest payments for the firm's executives.

In this way, carried interest arrangements inherently incentivise private capital firm executives to integrate sustainability considerations into their investment decisions and value creation processes. This impacts sustainability performance in the real economy because private capital firms oversee or influence (depending on the level of ownership) the incentivisation of senior management at the fund's portfolio companies and, where sustainability considerations are material to the particular risk profile of the company or the fund's investment strategy, will use this influence to establish remuneration structures that reward strong ongoing performance of the company against sustainability-related KPIs.

Sustainability-linked carried interest arrangements may be appropriate for certain impact strategies

There are some examples of private capital firms creating carried interest arrangements where the payment of a certain percentage of the carried interest depends on the fund achieving a certain level of performance against high-level sustainability-related KPIs. Such arrangements may sometimes be appropriate for funds pursuing certain impact or 'double materiality' investment strategies, whose binding purpose is to achieve both financial returns and a specified non-financial impact or sustainability-related objective. However, there are significant challenges in this approach for a more generalist investment strategy, including in relation the tension between the need for bespoke KPIs for different portfolio companies and the 'blind-pool' nature of private capital funds, where the firm does not know what companies the fund will invest in before it has been raised and starts investing.

As a result of the above, we do not think further regulatory requirements to link sustainability to remuneration are needed at this stage, especially as the market is at an early stage of development and further innovation is likely. Any new requirements that are introduced in future should again remain high-level, proportionate and principles-based. We would like to refer the FCA to the approach adopted by the EU, where firms are required to disclose how their remuneration policies "are consistent with the integration of sustainability risks", as an example of how firms have been encouraged to consider sustainability related risks in the context of remuneration without the introduction of prescriptive rules.

Training and competence

We agree that private capital firms managing institutional investors' capital should be required to have an appropriate level of understanding of and competence in relation to material sustainability issues and that a degree of capacity-building is required across financial services.

However, sustainability remains an emerging area, and it continues to grow and evolve at a rapid pace. If regulation is too prescriptive as to sustainability-related training and capability-building, it may have a negative impact on embedding climate and sustainability-related considerations across a firms' operations. Allowing for flexibility would likely be the most effective way for regulation to support positive sustainable change.

Proportionality is again important. The degree of expertise required for a firm to meet its fiduciary duty to its investors will vary according to the size of firm and the sustainability profile of the fund products the firm manages. In our view, firms should already ensure a certain level of competency in relation to the consideration of sustainability risks as part of their fiduciary duty. Any further, regulatory requirements to ensure the appropriate level of competency must remain proportionate to the size of the firm and the materiality of sustainability risk to the funds the firm manages. The application of proportionality to firms managing funds whose investment strategy is to pursue sustainability opportunities or impact investments may lead to a higher degree of sustainability expertise being required.

However, in all cases the FCA should bear in mind the still relatively nascent market for sustainability expertise both amongst potential employees and amongst third party suppliers, and only develop its expectations at a rate appropriate to the development of the market.

Please do not hesitate to get in touch if you have any questions or if you would like to discuss any of the above in more detail (please contact Tom Taylor (ttaylor@bvca.co.uk) and Harriet Assem (hassem@bvca.co.uk).

Yours faithfully,

Tim Lewis

Chair, BVCA Regulatory Committee