bvca The voice of long-term investment

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BY E-MAIL
Mr Jean-Paul Servais
Investor Protection and Intermediaries Standing Committee
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Dear Mr Servais,

CESR Technical Advice to the European Commission in the context of the MiFID Review - Client Categorisation: Consultation Paper

This response is made by the Regulatory Committee of the British Venture Capital and Private Equity Association ("BVCA"). The BVCA represents the overwhelming majority of UK-based private equity and venture capital firms.

Thank you for allowing us to submit our comments after the official deadline. Unfortunately, the short time limit allowed for consultation coincided with the principal holiday season, which made collating our comments more difficult. We have answered only the questions which we think raise relevant issues in a private equity/venture capital context. We have also raised a further issue not specifically covered by the consultation but which we think is important and likely to become more so on the introduction of the Alternative Investment Fund Managers Directive ("AIFMD").

We welcome the European Commission's attention to client categorisation issues in the context of its review of the Markets in Financial Instruments Directive ("MiFID"). The principal issue for the private equity/venture capital industry is that the concept of professional clients is drawn with reference to concepts and persons relevant to the wholesale and retail financial markets and is not suitable for the private equity/venture capital industry. As a result, persons who on any objective measure are professionals in a private equity/venture capital context are not always eligible to be treated as such under MiFID. CESR's proposals would in some cases make this position worse.

General comment

MiFID presents a challenge because of the breadth of activities that it covers. Some of the implementation issues identified by CESR arise because MiFID was conceived with a public equity mindset. We do not think that the solution is to make the definitions ever more narrow and prescriptive. We think that more has to be done to calibrate the concepts to the different markets. In this context it is important not to lose sight of the following facts:

- if a firm wrongly classifies a client as professional that should be retail, then we believe that that client is a retail client, entitled to retail protections and the firm is liable as a result - i.e. the firm bears the risk of the wrong classification. If CESR thinks this is not clear from MiFID then it should be made so. Once this principle is accepted then the case for making definitions more flexible is clearer - it is the firm that bears the risk.

- MiFID requires firms to tell clients that they can opt for retail treatment and of the difference between retail and professional clients. This is an important protection. An institution should at

least be able to read this and think about the implications, regardless of the extent of its investment experience. We consider that MiFID allows certain institutions and large companies to be treated as professional even if they do not have knowledge and expertise on the basis that their general commercial standing equips them to consider the information they are provided with and to decide if they need further protection. The MIFID client classification regime should not be revised so as to offer large companies the ability to be treated as professionals so as to get access to products that would not be available to retail clients, whilst at the same time having a one way option of complaining about their classification if they subsequently do not like the results of their investment.

Scope of Annex II.I(1)

CESR states that it believes that the scope is set by the opening sentence of the chapeau. In our view, the provision is not as clear as it could be.

Our principal concern is however that the provision does not work well in an international context, when EU firms are providing services to clients outside the EEA, and can put EEA firms at a commercial disadvantage in the global markets. Firms who are "professional" in the sense that their business falls within (1) (a) to (i) and which are required to be authorised or regulated under MiFID or some other national regime may not be so in other countries, or there may be a regime which is not an authorisation regime. These non-EEA clients will be treated as professionals in their own markets and by other service providers. EEA firms are at a disadvantage if they are not able to provide services to them on that basis. Such an approach confers no benefits on EU citizens.

We suggest therefore that if the provision is clarified to reflect CESR's view, then the introductory wording should state:

> "Entities which are required to be authorised or regulated to operate in the financial markets. The list below should be understood as including all authorised entities carrying out the characteristic activities of the entities mentioned: entities authorised by a Member State under a Directive, entities authorised or regulated by a Member State without reference to a Directive, entities authorised or regulated by a non-Member State, and also entities established in a non-Member State whose business comprises the carrying out of the characteristic activities of the entities mentioned and which are not required to be so authorised or regulated under the law of any jurisdiction in which they carry on business."

Do you believe that there is a need to clarify the language in points (c), (h) and (i) of Annex II.I(1) and if you do how do you think the language should be clarified?

"other institutional investors"

We agree that "other institutional investors" is intended to, and should, cover institutional investors not covered in the other paragraphs of Annex II.1(1). We do not agree however that the definition should be qualified by reference to entities "whose main activity is investing in financial instruments". The important criterion is already in the chapeau, requiring them to be authorised or regulated to operate in financial markets. No other qualification is required. In addition:

(a) the concept of a main activity in the context of an entity which has a number of activities is notoriously difficult to ascertain. An investment firm might well not be in a position to assess what the main activity of an institution is - indeed the institution itself might have difficulties. Take, for example, a major investment bank - if the test had to be applied to it (which we accept it would not as it would fall within Annex II.1(1)), could anyone be confident that its main activity was investing? We suggest not. Similarly, a large industrial company might have significant own account investments - but unless its investing activity were carried out by a subsidiary, its main activity would remain its industrial business even if its trading activities were more significant than those of many investment firms;

(b) is there intended to be a difference between investing and trading? We would have thought that any such distinction would not make sense;

(c) there is also some disagreement as to what is meant by "financial instruments" as defined in MiFID. Despite the Commission Q&A there are still some who consider that shares in companies

which are not publicly traded are not financial instruments. If this were correct (and we do not think it is), the revised definition would prevent private equity firms from treating an institution as professional in respect of private equity transactions, even though the institution had a track record in non-public investment;

(d) we think it is essential that the "other institutional investor" category is not narrowed as CESR suggests. It is already the case that the MiFID client classification provisions do not adequately correspond to the range of activities and instruments covered by MiFID and the types of "professional" investor that can be encountered outside of the traditional equity markets. In many cases the "other institutional investor" category is the only suitable category available for entities which are professional investors in particular markets. For example, when considering forms of closed or open ended collective investment (shares or units), an "institutional investor" could be a firm which has significant investments both directly in the underlying asset class as well as through shares or units. The underlying asset class might not be a financial instrument at all. Property investments are a classic example of this. To tie the concept of an "institutional investor" in all cases to a person whose main activity is investing in financial instruments would exclude, for example, a professional property investor, regulated in respect of indirect investments, who invests directly and indirectly, even though it is clearly, on any analysis, a professional in the asset class concerned. As we explain below, the "opt up" provisions are not adequate to deal with this situation.

For the reasons given above, and those under "General comment", we do not support further changes to the "other institutional investors" category.

Nor do we see the need to link (c) to the CRD definition of financial institution - this definition is used for an entirely different purpose in the CRD and the concept of "principal activity" would raise the same issues as noted above in relation to "main activity". However, whilst we see no need to define financial institution the concept of institutional investor could perhaps usefully be clarified, and whilst the categories of institutional investor used in (1) (a) to (h) provides a useful starting point, they are clearly not exhaustive.

Other comments

The Commission did not invite CESR to consider the "professional on request" category, which is of significant concern to the private equity and venture capital industry. We think that CESR's discussion on extending the requirements on firms to assess knowledge and experience has a natural link to this issue. If there is to be a regulatory requirement on firms to assess knowledge and experience in certain cases then there is no reason why this cannot be used to develop a more appropriate means of assessing who is truly "professional" in a particular sphere. The present MiFID tests bear no resemblance to what is "professional" in a private equity or venture capital context – the prescriptive tests are arbitrary and inappropriate.

MiFID requires two out of three tests to be met. We explain below, with reference to them, why they need to be changed.

1. The client has carried out transactions in significant size on the relevant market at an average frequency of 10 per quarter over the previous four quarters.

   This is inappropriate because the length of time that a single private equity or venture capital investment takes to source, negotiate and complete means that not even the largest, most active private equity funds would carry out ten private equity deals per quarter. The prospect that anyone else would do so is therefore unreal. A business angel investor will not make 40 venture capital investments a year, yet he will have considerable expertise in venture capital investment. The blanket application of a test that can never be met in a private equity/venture capital context means that the MiFID "opt-up" provisions do not truly correspond to those persons who are truly professional in this context.

2. The size of the client's portfolio of cash deposits and financial instruments must exceed EUR 500,000. In many cases of professional private equity investors this will be met, but the arbitrary limit excludes many staff employed as professionals in private equity/venture capital firms who undoubtedly have real expertise and knowledge in the relevant field.

3. The client works or has worked in the financial sector for at least a year. This makes little sense

in a private equity context. Many truly "expert" investors are themselves entrepreneurs who have worked in private equity backed firms, or are business angels. They have real knowledge and experience of the risks of backing developing companies, and yet this is treated as "irrelevant".

We think that the MiFID client classification review should not be limited to considering the risks of classifying certain entities as professional when in CESR's view they may not be. It should also consider what is needed to calibrate better the existing tests so that entities are not inappropriately excluded from the "professional" class.

Part 1 of CESR's Consultation Paper highlights the importance of professional clients under MiFID having "the knowledge and expertise to make their own investment decisions and properly assess the risks they incur" (see paragraph 18). This should be the determinative criterion for eligibility to be a "professional on request".

In our view, the test must be rephrased so as to require firms to be able to demonstrate why in their particular context a person is professional, to share that analysis with the client, as well as providing the warnings and advice on client status already required by MiFID. A similar regime operated in the UK pre-MiFID and still does for non-MiFID business. We are not aware of any regulatory concerns arising out of the use of this process (which is much used in the UK) in a private equity and venture capital context.

This issue is now even more acute in light of the proposed AIFMD. This is because the Commission's initial proposal for the AIFMD, and the texts recently adopted by the Council and the Parliament each use the MiFID "professional client" concept as the basis for the AIFMD's definition of "professional investor". Unless the changes we suggest are made, it will not be possible to allow experienced and knowledgeable individuals to invest in venture capital funds as professional investors, as they do now, and this would cut off an important source of funding for small and medium sized enterprises.

We would be happy to discuss any aspect of the above if that would be helpful. Please contact me in the first instance on +44 (0)20 7295 3233 or at margaret.chamberlain@traverssmith.com.

Yours sincerely,

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