bvca The voice of long-term investment

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By Email only

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Dear Sirs

Industry Response to the European Commission's Public Consultation on Review of the Markets in Financial Instruments Directive ("MiFID").

This response to the European Commission's Public Consultation on the Review of MiFID published by the European Commission on 8 December 2010 is made by the British Private Equity and Venture Capital Association (**"BVCA"**). The BVCA represents the overwhelming majority of UK-based private equity and venture capital firms.

In order to focus our response appropriately we have answered only those questions which we think raise issues relevant to the private equity and venture capital industry.

We would be delighted to discuss any of these issues with you.

Yours faithfully

Margaret Chamberlain
Chair – BVCA Regulatory Committee

Introduction

Private equity and venture capital are a specialist asset class dedicated to business growth. Normally the bulk of the assets of a private equity or venture capital fund are illiquid. Even when some assets are potentially liquid (e.g., in public company shares) they will generally be acquired as a first step in pursuit of a longer term strategy than is normal for public market investors (e.g., a public to private management buy out or the development of a technology or business) and the normal holding period for private equity and venture capital investments is greatly in excess of the normal holding period for public company investments. As a result, the volume of transactions undertaken by private equity and venture capital firms is extremely low compared to other asset managers, and it is not uncommon for there to be no transactions at all in individual quarters.

The application of MiFID to private equity and venture capital firms is, therefore, different to other firms within the investment management and advisory sphere and, in particular, to firms which deal with retail clients or in liquid equities. Our response to this consultation is therefore focused on the impact of the proposed changes to private equity and venture capital firms bearing in mind their unique position within the financial services industry.

Scope

As general comments we note that:

- even after the implementation of the Alternative Investment Fund Managers' Directive (**"AIFMD"**) there will be firms which are discretionary asset managers or advisers who operate only in relation to private equity and venture capital investments. We therefore continue to have an interest in the future application of MiFID.

- there is no common approach across Europe to the application of MiFID to private equity and venture capital activity. In some countries we understand that securities of private companies are not considered to be within scope, and indeed some aspects of MiFID are ill suited to them. Much greater clarity is needed on the scope of MiFID in this respect, i.e. as to its application to securities of private companies in the context of typical venture capital and private equity activity. Any proposals to extend provisions which currently only apply in respect of shares admitted to trading on regulated markets will need

careful consideration to be satisfied that they are capable of application to securities issued by private companies.

- the Commission is proposing, in a number of areas, much more detailed legislation and requirements on firms. If these are adopted there must be a recognition that, given the scope of MiFID, a "one size fits all" approach will not be appropriate. What is appropriate in terms of organisational structure and conduct of business rules for a small venture capital or private equity firm, investing in long term illiquid instruments will be different to that suitable for a large investment bank. The concept of proportionality will be very important in this context.

SME markets

(25) What is your opinion of the suggestion to introduce a new definition of SME market and a tailored regime for SME markets under the framework of regulated markets and MTFs? What would be the potential benefits of creating such a regime? **(26) Do you consider that the criteria suggested for differentiating the SME markets (i.e. thresholds, market capitalisation) are adequate and sufficient?**

Response:

We naturally support all efforts designed to assist small growing companies. We support EVCA's suggestion that the need for an SME market and how it might work be considered by an expert group, which should contain representatives of SMEs. If a market results with certain differentiating criteria, it will be necessary to avoid hard thresholds which would lead to markets, participants and/or traded securities regularly changing characterisation depending on short term events.

Direct sales by investment firms and credit institutions

(86) What is your opinion about applying MiFID rules to credit institutions and investment firms when, in the issuance phase, they sell financial instruments they issue, even when advice is not provided? What is your opinion on whether, to this end, the definition of the service of execution of orders would include direct sales of financial instruments by banks and investment firms? Please explain the reasons for your views.

Response:

Most of the discussion leading to this question will not be relevant to our members. However there is one comment made in the text which suggests that the Commission may consider that firms selling securities are necessarily providing services to investors. We do not agree with this. It may be that this comment is to be understood narrowly, as referring to the situation where, say, a bank creates its own securities which it sells to its clients. We do not comment on that aspect.

Our concern is that any such relationship is dependent on the facts, and this must be recognised. Different situations may produce different outcomes, i.e. as to whether an investment service is being provided both to an issuer and an investor. Venture capital and private equity firms may employ so-called placing agents when raising funds for investment or when an investee company is seeking to raise further capital from new investors. As the Commission is aware our members operate long term illiquid funds raised from experienced investors, and their investee companies will usually issue securities that are not admitted to trading on regulated markets. Potential investors know that placing firms used by our members/their investee companies are acting for the fund or the investee company, not the investor. Indeed this will be made clear in the placing memorandum and often there will be an express acknowledgement obtained from the investor to this effect. In the normal course the placing agent is not acting at the same time on behalf of the issuer and the investor and is not providing the investor with a service.

Although it is necessary to ensure that the position is clear to the investor, in a private equity and venture capital context, the parties would not expect the arrangements to be otherwise. We cannot comment on the position in other markets but this is certainly not the parties' expectation in the venture capital and private equity field. To impose such duties on a placement agent could, in our view, give rise to irreconcilable conflicts of interest and make fundraising for our members and investee companies even more difficult.

The marketing material must be clear, fair and not misleading (on this point and in general) and if it were not we believe that the investor would have a remedy in most if not all jurisdictions, regardless of whether he is treated as receiving a service as a client. If any measure is required we suggest it is one under which firms are obliged to make clear the capacity in which they are acting, and they must not then, through their actions, create a different impression.

Investment advice

(94) What is your opinion about introducing an obligation for intermediaries providing advice to keep the situation of clients and financial instruments under review in order to confirm the continued suitability of the investments? Do you consider this obligation to be limited to longer term investments? Do you consider this could be applied to all situations where advice has been provided or could the intermediary maintain the possibility not to offer this additional service? Please explain the reasons for your views.

Response:

We considered this proposal from the perspective of a venture capital/private equity fund manager, where an investor in the fund has been introduced by an intermediary. In such a case either the investor invests directly and then receives information directly from the manager, or the intermediary invests and receives information which he can pass on. The investment is a long term commitment and the investor will be in breach of contract if he reneges on that commitment. The suitability of the investment has to be assessed up front, there can be no question that the investor can withdraw at a later point. Accordingly the investment should not be assessed as suitable in the first place for an investor who is unable to make such a commitment. A later review would be of no use and risks causing disruption for other investors, if they find that one of their number has withdrawn. This proposal is therefore not suitable for long term fixed commitments.

Informing clients on complex products

(95) What is your opinion about obliging intermediaries to provide clients, prior to the transaction, with a risk/gain and valuation profile of the instrument in different market conditions? Please explain the reasons for your views.

(96) What is your opinion about obliging intermediaries also to provide clients with independent quarterly valuations of such complex products? In that case, what criteria should be adopted to ensure the independence and the integrity of the valuations?

(98) What is your opinion about introducing an obligation to inform clients about any material modifications in the situation of the financial instruments held by firms on their behalf? Please explain the reasons for your views.

Response:

Whether an intermediary is even able to provide such information will depend on the product and the information available. If a fund were to be considered "complex" (and we do not agree that it necessarily is) the valuation requirement would become unnecessary for funds within the AIFMD because of the valuation requirements to which that Directive subjects in-scope managers. In any event it is not clear to us that an intermediary would have or be able to get the necessary information. Any such proposal needs to be more tailored to the instruments (if any) which are causing concern.

Inducements

(101) What is your opinion of the removal of the possibility to provide a summary disclosure concerning inducements? Please explain the reasons for your views.

(102) Do you consider that additional ex-post disclosure of inducements could be required when ex-ante disclosure has been limited to information methods of calculating inducements? Please explain the reasons for your views.

Response:

The summary disclosure is essential for private equity and venture capital investment managers. Due to the breadth of the inducement rule it captures payments which are not within the usual meaning of "inducement" and where there are not conflict issues to be managed. For example, in our context the fact that a manager may receive, say, directors' fees, is likely to fall within the inducement rule. Yet at the time that an investor subscribes to a fund, the amounts will not by definition be known - the manager has no idea what investments he will make or on what terms. He can only make a summary ex-ante disclosure. In the experience of our members this is clearly understood by investors and the whole issue of payment and accounting for such fees is negotiated at the outset with investors. The Directive cannot mandate the provision of information that is not known. The possibility to provide a summary disclosure recognises this.

We do not, therefore, agree with the proposed removal of the possibility to provide summary disclosure concerning inducements. The current rules permit investors to receive a sufficient level of information in advance of making investments and we do

not consider that further detail would be of any benefit to investors. As outlined above, it may be difficult to apply such additional requirements to private equity and venture capital firms where the requisite level of detail would not be known in advance.

We do not consider that ex-post disclosure should be required. The existing rules require a sufficiently detailed level of information to be disclosed and where investors require further information they are at liberty to ask. In the case of private equity and venture capital firms the information is in any event provided through the accounts and reports to investors and may also be part of the process by which firms manage their conflicts.

(103) What is your opinion about banning inducements in the case of portfolio management and in the case of advice provided on an independent basis due to specific nature of these services? Alternatively, what is your opinion about banning them in the case of all investment services? Please explain the reasons for your view.

Response:

As noted above, the inducements rule is so wide and uncertain in scope that it is generally interpreted as applying to payments which are not "inducements" in the sense of being payments that might be thought to induce a firm to act against its clients' best interests. The rule extends beyond situations involving potential conflicts of interest. Therefore to ban the payment or receipt of inducements for any MiFID firm will have far reaching consequences for commercial activity.

We do not see the need for any ban and any extension of such kind would need to be very carefully targeted. The existing inducement rule is so stringent that it is difficult to see what more is required at a legislative level to protect clients. In our view the focus should be clearer guidance and more even enforcement.

A ban may have the unintended effect of restricting a firm's ability to continue performing its investment activities in its clients' best interests. Whilst the BVCA supports regulation which aims to prevent corruption or practices that are not in clients' best interests, we do not consider that a ban on inducements would assist in reaching that aim. Existing legislation on anti-corruption and conflicts of interests already complements the existing rules on inducements and provides comprehensive regulation of the issue.

Private equity and venture capital firms within MiFID may be investment managers or advisers and a prohibition on inducements could severely disrupt their business, put them at a disadvantage when competing for investors from outside Europe and be of no benefit to investors. Payments common in their business which may be within scope include receipt of directors' fees for investor directors of investee companies. The treatment of inducements/fees that a manager might receive from others is not only disclosed to investors but also always heavily negotiated when settling the fund documentation. The fund documents will therefore cover the basis on which fees received from third parties are dealt with. For example such fees are often rebated in whole or in part to the fund, reducing investor costs by adjustments to the management fee. As all investors invest on the same terms, all investors benefit from the negotiating of others.

Such payments are a legitimate part of private equity and venture capital firms' activities. If the Commission has a particular issue with certain payments in certain markets it should target these.

Client classification

(104) What is your opinion about retaining the current client classification regime in its general approach involving three categories of clients (eligible counterparties, professional and retail clients)? Please explain the reasons for your views.

Response:

We consider that the current client classification system is an appropriate and proportionate approach to the treatment of clients and potential clients. The existing rules permit sufficient flexibility for clients with knowledge and experience to be treated accordingly whilst the requirements for risk warnings ensures clients continue to be treated fairly. However, the regime categories are not sufficiently adapted to non-liquid equity business, particularly the private equity and venture capital business.

This will have a potentially more serious effect given the use of the same concept in the AIFMD. This may work to deprive European companies of the range of investors that would be willing and able to invest in funds designed to provide capital to growing businesses.

This is because the marketing passport which is being introduced under the AIFMD can only be used where marketing is to "professional investors" – i.e. someone who

falls within the category of "professional client" under MiFID. From the perspective of the private equity and venture capital fund industry, the definition of "professional clients" under MiFID is therefore increasingly crucial.

Currently under MiFID, a potential investor may only be treated as an elective professional client where an investment firm has carried out an adequate assessment of the expertise, experience and knowledge of the client which gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved. In the course of the above assessment, as a minimum, two of the following criteria must be satisfied:

- 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;
- the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500 000; and
- the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

(Annex II of MiFID)

Currently most private placement regimes in Member States allow marketing of unregulated funds (including private equity/venture capital funds) to high net worth individuals and/or sophisticated investors and for certain types of fund managers. The ability to have these types of investor is of crucial importance. However the vast majority of these types of investors will fail to qualify as "professional investors" under the MiFID definition, primarily because, as we have said many times, not even the largest private equity fund manager enters into ten deals per quarter, every quarter. As a result the definition excludes individuals (such as high net worth business angels and entrepreneurs) and smaller corporates who are truly professional in the field.

Managers would then have to rely on individual Member States allowing marketing to "retail" investors under Article 41 of AIFMD.

We suggest that an alternative test be designed for identifying expert investors in the private equity and venture capital markets and we would welcome the opportunity to discuss what might be appropriate. Our members are already used to applying such a test for non-MiFID business in the UK, where it has worked well, enabling firms to deal with business angels and similar investors.

In view of the use of the definition in the AIFMD we believe that it is the correct time to review the definition to make sure it is fit for purpose.

(106) Do you consider that the current presumption covering the professional clients' knowledge and experience, for the purpose of the appropriateness and suitability test, could be retained? Please explain the reasons for your views.

Response:

We think that the current presumption covering professional clients' knowledge and experience should be retained. Alternative approaches, including information gathering from professional investors in advance of dealing with them as a client, would lead to significant and unnecessary delays in the take-on process. Furthermore certain investors may be unwilling to share information with the firm.

Liability of firms providing services

(107) What is your opinion on introducing a principle of civil liability applicable to investment firms? Please explain the reasons for your views.

(108) What is your opinion of the following list of areas to be covered: information and reporting to clients, suitability and appropriateness test, best execution, client order handling? Please explain the reasons for your views.

Response:

Whilst we can see the benefit of a level playing field in this respect, we also think that many of the rules are too general to form a proper basis for imposing civil liability; they are designed for interpretation by supervisors, not courts. National legal systems adopt their own approaches. In the U.K. there is an Ombudsman Scheme, which supplements existing civil remedies whilst not replacing court action. If there is any such regime it should only apply to defined precise rules and to retail clients.

Execution quality and best execution

(110) What is your opinion of the requirements concerning the content of execution policies and usability of information given to clients should be strengthened? Please explain the reasons for your views.

Response:

We note that if there are to be any detailed requirements they must be sufficiently flexible to recognise that the concept of markets, execution venues and execution quality have very little resonance for venture capital and private equity transactions which are negotiated, often over several months and each transaction is unique.

Compliance, risk management and internal audit functions

(114) What is your opinion on possible MiFID modifications leading to the reinforcing of the requirements attached to the compliance, risk management and internal audit function? Please explain the reasons for your views.

Response:

Venture capital and private equity firms may be small in size, e.g. with only a handful of executives. Any such proposals must be proportionate to the size of the firm and the nature of its business, risk profile etc.

Conflicts of interest and sales process

(118) Do you consider that implementing measures are required for a more uniform application of the principles on conflicts of interest?

Response:

We doubt this is possible given the wide range of businesses and hence conflicts that could arise. For example the IOSCO work on conflicts in private equity is highly relevant to our members whereas measures designed for other businesses would not be, and vice versa.

Telephone and electronic recording

(129) Do you consider that a common regulatory framework for telephone and electronic recording, which should comply with EU data protection legal provisions, could be introduced at EU level? Please explain the reasons for your views.

Response:

The BVCA supports and agrees with measures that promote the reduction, prevention and detection of market abuse and market manipulation. Given the illiquid stock in which private equity and venture capital firms invest, there is very limited scope for such firms to commit this type of financial crime. If such a firm does deal in a public security it should not be subject to a recording requirement provided that either it is (i) in contact with another firm which is subject to the requirement, or (ii) the number of calls that it makes are de minimis compared with its general activity. This would make the proposals more targeted and improve the cost-benefit analysis.

If the Commission were to introduce a common regulatory framework for telephone and electronic recording without including such provisions this would lead to the unnecessary regulation of firms including private equity and venture capital firms. Existing anti-financial crime laws govern all firms and it is correct that additional measures cover only those firms posing the highest threat to the markets.