Dhan Paramasivam
Financial Conduct Authority
Consumer Investments Distribution Policy
12 Endeavour Square
London
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By email: cp23-14@fca.org.uk

10 July 2023

Dear Dhan

Re: Amendments to the ban on offering incentives to invest in high-risk investments

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 700 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 equity and venture 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.

What is venture capital?

Venture capital (VC) provides finance and operational expertise for entrepreneurs and start-up companies in a variety of sectors important to the growth and success of the UK economy, including information communication technology, life sciences and fintech. VC funds invest in new companies with the potential for strong growth. Businesses seek VC investment to grow their operations, enhance product development and/or expand their business and increase head count. VC investors can also help founders make important decisions for growth, as many have deep expertise in their line of business but may lack the skills and knowledge needed to cultivate a growing company.

Many of the world's best-known companies began life with VC funding. In the UK, this includes the likes of Wise, allowing private individuals and businesses to send money abroad without hidden charges, Moonpig and Skyscanner, and globally household names such as Google, Facebook and Skype all received VC backing in their early stages.

VCs take minority stakes in businesses, often alongside other VC investors and typically hold their investments for between five and seven years, at which point the company can be floated on the stock exchange, sold to a multinational corporation or to another investor such as a private equity (PE) firm.

Who invests in VC funds?

Investors in VC funds are a mix of institutional investors (including pension funds, insurance firms and large financial institutions) founders, high net worth individuals (HNWI) and angel investors. While these investors have the expertise, experience and knowledge needed to be capable of making their own investment decisions and understand the risks involved, the "quantitative test" for MiFID business in COBS 3.5.3R (2) can be extremely difficult for investors in private capital. This is because private capital investors make relatively few transactions (not even large institutional investors make on average 10 relevant transactions per quarter), and investors' relevant experience is often in business, e.g. as entrepreneurs, and not in financial services as is required by the test. As a result, our members find that some sophisticated and high-net-worth investors, family offices, entrepreneurs, academic endowments, executives, directors, and employees of the firm that are involved in the management of the fund must be treated as retail investors despite having suitable experience and expertise equivalent to institutional investors ('per se' professional clients).

Q4.1: Do you have any comments on our proposed amendments to the ban on offering incentives to invest in high-risk investments?

There are [three] points we would like the FCA to consider when finalising the proposed Handbook rules and guidance related to the ban on offering incentives to invest in high-risk investments in:

1. The proposed carve out in COBS 4.12B.19G (2)
2. Tiered pricing: investing "beyond a certain level"
3. The impact on VC fund first closings

1. <u>The proposed carve out in COBS 4.12B.19G (2)</u>

We welcome the proposed clarification in new Handbook guidance at COBS 4.12B.19G (2) that "lower fees not linked to volumes, offered to all retail clients, do not constitute a monetary incentive" and the acknowledgement in paragraph 4.12 of the consultation paper that "firms are not prohibited from competing on price". Price competition invariably benefits investors, forms an important part of the product offering and can be an important consideration in investment decision-making.

In private capital funds, a typical fee structure is a combination of a fixed annual management fee, paid on the value of committed capital, and a performance-based element, calculated on investment returns over a pre-agreed hurdle rate, known as "carried interest". Carried interest is not strictly a fee, but a profit share arrangement agreed between investors and the fund manager (typically as partners in a limited partnership). These arrangements are the market standard means of aligning the interest of private capital firms with those of the investors in their fund(s) and are designed to reward sustainable and long-term growth in the value of the funds' portfolio companies.

We recommend that the final Handbook guidance in COBS 4.12B.19G (2) be amended to reflect that both lower 'fees' and 'profit-sharing arrangements' are not monetary incentives when offered to all retail clients. There is a recent precedent for this in the Department for Work and Pension's recent consultation on broadening the investment opportunities of defined contribution pension schemes. Following representation by the BVCA, the statutory definition of a "specified performance-based fee" was expanded by the Government in final regulations to mean "fees, profit-sharing arrangements, or any part of fees or profit-sharing arrangements" (see Regulation 2. (2)(v) of UK SI 2023 No. 399) to address this same issue.

We also suggest that the FCA considers including "costs, expenses and charges" alongside fees and profit share arrangements in the Handbook guidance, on the basis that lower costs, expenses and charges not linked to volumes and offered to all retail clients would similarly benefit retail investors and would be in-line with the FCA's policy intention as described in the consultation paper.

2. <u>Tiered pricing: Investing "beyond a certain level"</u>

There is helpful commentary in paragraph 4.13 on the distinction between permissible "tiered pricing" structures and banned incentives based on "volumes". We agree that tiered pricing structures are common practice and consumers benefit from such structures with lower fees when making investments over certain levels.

While the distinction is clear in the consultation paper, "volumes" is not a defined term in proposed Handbook guidance and could be misinterpreted by some. To provide certainty without firms needing to find and rely on the explanation in the consultation paper, we think it would be helpful for the Handbook guidance to state that lower fees and profit-sharing arrangements, etc. linked to tiered pricing structures based on how much an investor invests do not constitute a monetary incentive, or similar words to that effect.

3. The impact on VC fund first closings

The first close is a significant milestone in the private capital fundraising process. It means that the fund manager has attracted sufficient investment capital, typically at least a quarter of the minimum fund size, to admit investors to the fund and to start investing in portfolio companies. Private capital funds typically hold several closings at which investors commit to the fund before the final closing. The length of time taken to raise a fund varies depending on the investor networks and track record of the private capital firm.

Some managers offer preferable terms to investors who invest at the first closing, as a lower management fee and carried interest, known as an "early-bird discount", to reward early investor support and to try to even out the relative attractiveness for investors of investing at first closing or waiting for a later closing.

When a fund manager offers an "early-bird discount", it is typically offered to all investors, and is not time limited but ends at the first closing. It is not designed to and should not create time pressure or exclusivity that may cause investors to commit to the fund without carefully considering fund documents and the risks involved or encourage retail investors to make an investment that would not otherwise be made. The discounts to management fees and carried interest are typically modest – perhaps a 20bps discount to a management fee of 2%, or a carried interest of 18% rather than 20%, or can involve the disapplication of a higher rate of carried interest, such as a 25% carry above a 3x return. The aim of an early-bird discount is to balance out the relative advantages of investing at first closing or at a later closing, to reward investors who invest at the first closing, and to make it less attractive on a relative basis for investors to wait to invest at a later closing.

We think that the practice in the venture capital and private equity sectors of offering early-bird discounts to management fees and carried interest, as set out above, falls outside of the types of harmful inducements that the FCA is seeking to prohibit. These arrangements constitute a legitimate practice, and is of benefit to the UK-based venture capital and private equity fund management industry.

We would welcome some acknowledgement from the FCA that the practice in the venture capital and private equity sectors of offering an early-bird discount to management fees and carried interest:

1. is not automatically prohibited by the rules, but would need to be assessed on a case-by-case basis; and

2. is not likely to (or would not) constitute an incentive if it is made available to all retail investors at the first or early closings, is not limited to a fixed period of time, and is not designed to create and does not create time pressure or a sense of exclusivity that would cause retail investors to not fully consider the risks involved with their investment.

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 / Nick Chipperfield nchipperfield@bvca.co.uk).

Yours sincerely,

Tom Taylor

Head of Policy (Legal and Regulatory), BVCA