FCA DP 21/1 Strengthening our financial promotion rules for high-risk investments

Discussion Paper Questions

Question 1

Please provide any data related to:

a. the number of consumers who currently hold high-risk investments, the amount they hold and the type of high-risk investments they hold,

b. the number of issuers of high-risk investments, the amount they issue and the type of high-risk investments they issue.

We are responding as the British Private Equity and Venture Capital Association ("BVCA"), which is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 700 firms, we represent the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers and investors. Between 2015 and 2019, BVCA members invested over £43bn into nearly 3,230 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 972,000 people in the UK and the majority of the businesses our members invest in are small and medium-sized businesses.

The data below is from the BVCA's annual report on investment activity. This is a survey of BVCA members' fundraising and investment activity. Please note that this data includes both investments which are "high risk" in the FCA's classification (limited partnership interests, which are unregulated collective investment schemes) and investments which are "readily realisable securities" and therefore not high risk (shares in Venture Capital Trusts, which are admitted to trading on an exchange). There is an additional category, Enterprise Investment Schemes, which involves purchasing interests in shares in unquoted companies (non-readily realizable securities). "Private individuals" investing in these vehicles include persons connected with the investment manager. The below table demonstrates that the majority of investment in private equity and venture capital is not by private individuals, but there is some investment in these strategies:

Type of source	Location of investors	2017 £m	2018 £m	2019 £m
Private individuals	UK	2,059	937	1,462
	Overseas	558	550	1,008
Other sources	UK	3,961	3,811	3,903
	Overseas	26,411	28,821	40,639
	Unclassified	-	-	583
Grand Total		**32,989**	**34,119**	**47,595**

We understand most of the activity targeting individuals relates to VCTs and EIS's, i.e. it targets early stage investment in companies.

The table below reveals that the percentage of private individuals investing in venture capital funds as a proportion of the total fundraising was higher than in other types of funds. The venture capital category also includes EIS and VCT funds:

Private individuals investing in:	**2017**	**2018**	**2019**
Venture capital funds	34%	32%	19%
Growth capital funds	10%	7%	21%
Private equity funds	7%	3%	3%

Question 2

Are there any investments which are not currently subject to marketing restrictions which should be?

○ Yes

◉ No

○ No view

All investments in private equity and venture capital are subject to marketing restrictions. We do not offer a view on other market sectors.

Question 3

Should there be changes to how certain types of investments are currently classified for the purposes of our financial promotion rules to prevent arbitrage in the context of our SIS rules?

- ○ Yes
- ◉ No
- ○ No view

If yes, what changes are needed?

No, however, if the FCA to decides to widen the definition of SIS to stop regulatory arbitrage, we recommend limiting the change to a clearly defined additional category to which the definition of SIS applies, which would capture economically equivalent structures or interests that do not technically amount to debentures or preference shares but have the same economic effect, rather than seeking to bring all equity shares within scope. If all equity shares are SIS there is a risk that this could have significant unintended consequences by imposing largely unintended restrictions on the marketing of equity shares in commercial companies and corporate investment vehicles.

Please explain your answer, addressing the issues we identify in paragraphs 3.12 to 3.25 where appropriate.

See above.

Question 4

Are there any other features of an investment which means they are generally inappropriate for retail investors and should be subject to a mass-marketing ban?

- ○ Yes
- ○ No
- ◉ No view

If yes, what are the features?

Please explain your answer, addressing the issues we identify in paragraphs 3.26 to 3.28.

We think that not all early stage investments should be automatically classed as speculative and subject to the SIS, and would welcome greater consideration by the FCA of the effectiveness of the existing NRRS obligations for EIS schemes, and the potential effect on the EIS industry of including EIS schemes within the SIS category. EIS is an important source of funding for early stage UK businesses.

Question 5

Should we change the scope of securities covered by our RRS definition for the purposes of the financial promotion rules?

- ○ Yes
- ○ No
- ● No view

Question 6

Please provide any data you have about the potential impact of any changes discussed in chapter 3. For example: the number of consumers, issuers, firms and investments which might be impacted; the potential costs and benefits of any changes.

Question 7

Do you think more requirements should be placed on firms to ensure the accurate categorisation of retail clients?

- ○ Yes
- ● No
- ○ No view

If yes, what requirements should be introduced?

Our response focusses on the use of the certified high net worth and self-certified sophisticated investor exemptions. The certified sophisticated investor exemption is barely used for promoting interests in private equity and venture capital funds (we are only aware of a few examples). We agree that it is important to strike the right balance between firms' obligations and the regulatory principle that investors should take responsibility for their own decisions (and they should also be provided with sufficient information to do so).

We consider that the existing obligations correctly applied, with additional guidance, should be sufficient to ensure accurate categorisation of retail clients. The existing obligations under COBS are detailed and impose a number of general and specific obligations that are set out below.

1: A firm that promotes under the certified high net worth investor exemptions in the PCIS Order or FPO is required under COBS 4.12.9 to (a) have regard to its duties under the Principles (b) have regard to the client's best interests rule (c) take reasonable steps to ascertain that the retail client does, in fact, meet the income and net assets criteria set out in the relevant statement for certified high net worth investors (annual income of £100,000 or more, net assets excluding certain items including primary residence of £250,000), and (d)

consider whether the promotion of the non-mainstream pooled investment is in the interests of the retail client and whether it is fair to make the promotion to that client on the basis that the client is a certified high net worth investor, having regard to the generally complex nature of non-mainstream pooled investments.

2. A firm that promotes a non-mainstream pooled investment to a retail client under the self-certified sophisticated investor exemptions in the PCIS Order or FPO is subject (under COBS 4.12.12G) to the same requirements as are set out at (a) to (c) above, and is also required to consider whether it is fair to make the promotion to that client on the basis of self-certification, subject to a presumption that it should take reasonable steps to satisfy itself that the investor does in fact have the requisite experience, knowledge or expertise to understand the risks of the non-mainstream pooled investment in question.

In addition to the above, where the investor is based outside the UK, it may be appropriate for UK firms to market to them on the basis of the relevant exclusion in the FPO. This allows ultra-high net worth investors (e.g. net worth above USD 50m) to invest in funds operated by UK based fund managers. It is very important that the UK rules to not impose unnecessary additional burdens in marketing to this category of investor.

Please explain your answer, addressing the issues we identify in paragraphs 4.12 to 4.18.

General

Feedback from our member firms indicates that a principles-based and proportionate approach is important, as is avoiding prescriptive “one-size-fits-all” obligations on all firms across all industries and sectors that is likely to be disproportionate in the context of private equity and venture capital funds. In seeking to impose obligations to protect consumers from direct online sale of high risk investments, other more established sectors such as private equity and venture capital could be disproportionately affected, and attempts to recover or maintain the competitiveness of the UK could be eroded (see for example the German semi-professional investor category).

Factors to consider in applying a proportionate approach could include the type of transaction (including whether it is a one off purchase and sale or an ongoing relationship), and whether there is interaction between the investor and the firm. In private equity and venture capital funds it is common for relationships between successful fund managers and high net worth investors to continue over decades and multiple funds, and so categorisation is not a one-time process.

Specific actions

We consider that a non-exhaustive list of actions that firms could take to obtain reasonable assurance that a retail investor meets the relevant requirements would assist firms, and an obligation to document that reasonable assurance would seem appropriate. We set out below our thoughts on the actions proposed at paragraph 4.16 of DP 21/1.

Bank statements/payslips. We are concerned that a forced requirement to obtain bank statements or payslips would be counter-productive, would be seen as highly intrusive by many (and could deter some) high net worth investors, and would raise data protection issues. In certain situations this requirement may also be redundant, for example in relation to a successful FTSE CEO or a high-profile entrepreneur who holds a large stake in a publicly

listed company. We do not think that using technological developments such as open banking will change those underlying investor concerns.

Independent verification. We think some form of independent verification that a retail investor meets the requirements of being a high net worth or sophisticated investor could be appropriate, particularly where the transaction is online, without personal interaction and where the firm has had no previous interaction with the investor. A non-exclusive list of suitable independent verification could assist, for example confirmation from a credible source online source or third party that an individual is a founder of a high-growth business, inherited considerable wealth, or is a partner or managing director of a successful firm or bank.

Reasonable grounds. It is common for firms to have existing information from long-standing relationships with investors, which can often provide reasonable grounds to confirm that an investor meets the relevant requirements. We think it reasonable to allow firms to rely on that information if documented.

10% concentration limit. While we understand that some form of diligence that a potential investor is not investing disproportionately in a risky and/or illiquid investment may be appropriate in particular circumstances, requiring firms to confirm that all hight net worth or sophisticated investors will not invest more than a certain percentage of their liquid net worth would cause similar concerns and confidentiality issues as for bank statements above. We think it important to apply this on a proportionate basis, to not apply a universal rule, perhaps to only apply the requirement if certain red flags are identified, and for greater discretion where investment professionals are investing in funds that they manage or advise. In venture capital and private equity it is common for the investment team to be required to invest a proportion of the total fund commitments (generally between 1% and 2%, sometimes more) to ensure alignment of interest between the fund manager and the investors. For some junior investment professionals at the early stages of their career, their proportion of that investment may be a material proportion of their liquid net worth.

Red flags. We consider that a fixed monetary threshold above which greater scrutiny should be applied would have a disproportionate effect on the private equity and venture capital industries, as experienced investors often invest larger amounts. The appropriate red flag threshold level will vary considerably between investment products and sectors. In many venture capital and private equity funds, commitments will generally not be accepted below €100,000. It is common for higher thresholds of £1 million or more to be applied where fund managers either do not wish to increase the administration and reporting burden of a fund by admitting many investors with small investment amounts, or use a minimum investment amount to screen out all but ultra-high net worth private investors. A red flag threshold that might be appropriate for other types of investment (say, £100,000 for speculative mini-bonds) would be arbitrary and impose disproportionate diligence obligations - particularly on venture capital fund managers – with little corresponding benefit of more effective investor classification.

Question 8

Do you think changes should be introduced to help consumers better categorise themselves?

- ○ Yes
- ○ No
- ● No view

If yes, what changes should be introduced?

We think a standardised enhanced risk warning or confirmation at the point that an investor confirms that they are a high net worth or sophisticated investor could assist. We agree that risk warnings should be shorter, sharper, written in plain English, not overly legalistic and accessible to the class of recipient (paragraph 4.25 of DP 21/1). We think that the most effective way to achieve this would be enhanced standard warnings and confirmations, in line with the current approach of short form confirmations in the high net worth and sophisticated investor standard forms.

Banning pre-ticked confirmations and including clear, express questions may assist in more effective investor categorisations, and we would expect that should be borne out in the FCA's further testing.

Allowing investors to provide further information on why or how they meet the high net worth or sophisticated investor requirements would be appropriate, and, from BVCA member feedback, is common practice. However, forcing investors to disclose information that they consider sensitive, such as salary, net assets, amounts invested in similar investments (which could be investments in competing funds) would raise confidentiality concerns for many high net worth investors in funds.

Please explain your answer.

See above.

Question 9

Do you think the risk warnings we introduced for SISs should be applied more broadly?

- ○ Yes
- ○ No
- ● No view

If yes, what investments should they apply to?

See response to question 8 above.

Please explain your answer, addressing the issues we discuss in paragraphs 4.27 to 4.33.

See response to question 8 above.

Question 10

Do you think visual based risk warnings should be introduced for high-risk investments?

- ○ Yes
- ○ No
- ◉ No view

If yes, what visual based risk warnings should be introduced?

While visual based risk warnings could be useful for certain products, we think they could be misleading; for example, investors may view access to the FSCS to be some form of kitemark. A traffic light system is likely to be overly simplistic and could be misunderstood by some recipients. While a set of standard visual based risk warnings could be useful for certain products (and may allow consumers to compare products' relative risks on a high-level basis and so therefore the visual risk warnings could be standardised), we think it is important that their use should be voluntary rather than obligatory (i.e. firms could elect to apply the visual based warnings as a set, or not at all).

Please explain your answer.

See above.

Question 11

Do you think additional 'positive frictions' should be introduced to the consumer journey for high-risk investments?

- ○ Yes
- ◉ No
- ○ No view

If yes, what changes should be introduced?

We think any positive frictions to investment should be proportionate and targeted at the most high-risk investments. We appreciate the difficulty in identifying positive frictions that would cause investors to seriously reflect and consider their classification and/or the investment.

From the point of view of the competitiveness of the UK regulatory regime, it seems important to not impose additional obligations on firms that do not achieve that effect.

We also consider that any such rules should not apply to ultra-high net worth individuals. In reality there is no difference between these individuals investing themselves or through a company they have set up (where the restrictions would not apply).

Please explain your answer.

To respond to the proposals for positive frictions in DP 21/1:

Cooling off period. A cooling off period presents particular issues for illiquid investments, including interests in investment funds. If a cooling off period was implemented, it is likely that the investor with a cooling off right would not be drawn down (or that the proceeds of its commitment would not be invested) until the cooling off period had expired. This is because if an investor exercised its cooling off right, it would be difficult to unwind and repay an investment (for example, in an early stage private company), or to unwind an equalisation between new and old investors, or arrange a secondary sale of a fund interest held by that investor. As investors typically expect their commitment to be invested, it would be reasonable to allow any cooling off period to be waived for illiquid investments or interests in unregulated collective investment schemes and equivalent products, perhaps subject to a standard, clear risk warning setting out the effect of waiving that right.

SMS confirmation. While an SMS confirmation could require further action, we consider sending or receiving an SMS to be unlikely to cause an investor to reflect on its investment.

Just in time educational videos. While making educational videos (that are subject to financial promotion rules and content requirements) available may assist investors, we think it disproportionate for them to be required before contracting.

Passing an online test to demonstrate sufficient knowledge about financial products. We consider it disproportionate to require an online test about financial products, which would be difficult to calibrate. A high level general knowledge test relating to generic financial products could only be of general application and use, whereas a product specific test would be challenging to set at the correct level given potential wide ranges in culture, language, education and numeracy.

Question 12

Please provide any data you have about the potential impact of any changes discussed in chapter 4. For example: the number of consumers, issuers, firms and investments which might be impacted; the potential costs and benefits of any changes and evidence of the potential effectiveness of the changes.

Question 13

Do you think new ongoing monitoring obligations should be introduced for section 21 approvers?

- ○ Yes
- ○ No
- ◉ No view

Question 14

Do you think changes should be introduced to the role a section 21 approver in the client categorisation, appropriateness and preliminary suitability assessment processes?

- ○ Yes
- ○ No
- ◉ No view

Question 15

Please provide any data you have about the potential impact of any changes discussed in chapter 5. For example: the number of consumers, issuers and investments which might be impacted; the potential costs and benefits of any changes.

Question 16

Do you have any other comments you would like to make on the topics covered in this Discussion Paper?

We agree with the FCA's aim of addressing the harm to consumers from investing in inappropriate high-risk investments which do not meet their needs (paragraph 1.3 of DP 21/1), particularly in light of online and social media distribution channels to mass retail investors, and the increasing popularity of what are perceived to be more innovative, high-risk and high-return products, including products relating to cryptocurrency. We also agree that it is important to balance what is feasible for firms to implement, protecting consumers and consumers taking responsibility for their own actions, and to identify any unintended consequences of proposed changes (paragraph 1.6 of DP 21/1).

High net worth and sophisticated investor exemptions are used to market a proportion of private equity and venture capital funds. Most private equity fund managers generally only market to per se or elective professional investors (under the MiFID definitions). The use of those exemptions is more common for venture capital fund managers, who manage funds that invest in early stage high growth businesses. As an industry we are concerned that the

operational cost of any additional client classification obligations would most impact smaller venture capital fund managers who typically manage smaller sized funds (£50 million or smaller funds are common), have more limited financial resources, and would have fewer staff available to perform those additional client classification obligations. Therefore, it is of particular importance to the venture capital fund industry that any additional classification obligations are proportionate and are justified by the benefits of more effective investor classification for higher risk potential investors and transactions

We have limited the scope of our response as follows:

Chapter 3 – classification of high-risk investments. We have only responded on the expansion of the SIS definition to all equities. Interests in unregulated collective investment schemes are already Non-Mainstream Pooled Investments so would already be caught by the proposals.

Chapter 4 – proposals relating to the categorisation, risk warnings and positive friction. We have responded to the questions relating to this chapter, which are relevant to the private equity and venture capital industry.

Chapter 5 – use of a s.21 approver. We have not responded to the questions relating to this chapter. Private equity and venture capital firms are typically authorised firms and the practice of using authorised firms to approve financial promotions is rarely if ever used.

We would very much like the opportunity to discuss with the FCA any new rules before a CP is published to test whether this could inadvertently cause disruption to the UK industry and the UK's place in the global private equity and venture capital industry.

If you have any questions when completing the survey, please contact the following email address: Financial_Promotions_DP_2021@fca.org.uk