Paul Rich/Hillary Neale
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

By email: cp20-24@fca.org.uk

8 February 2021

Dear Mr Rich, Ms Neale

Re: BVCA response to FCA CP 20/24: A new UK prudential regime for MiFID investment firms

We are writing on behalf of 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.

Summary Feedback

We are extremely grateful to the FCA and HMT teams who are working on implementing this mandate for the time they have taken to engage constructively with us on the issues arising from DP 20/2, prior to the publication of this CP 20/24. We look forward to continuing positive engagement in order to support the FCA's stated objective of avoiding an inappropriate or excessive regime that does not align with actual business models, or address the risk the firms pose.

As we described in our response to DP 20/2, the UK Investment Firm Prudential Regime ("IFPR") will result in significant changes to the capital, liquidity and remuneration requirements applicable to investment firms currently classified as exempt CAD firms. BVCA member firms could be amongst those most affected by IFPR, despite the negligible level of systemic risk they pose.

We have set out our detailed responses to the questions posed in the Consultation Paper in the Appendix to this letter.

Below we summarise the key issues for our members arising from CP 20/24.

1. KEY COMMENTS ON CP 20/24

1.1 Transitional provisions

- We **welcome the proposed transitional period** in relation to the own funds requirements for exempt CAD firms, as set out in the Consultation Paper. We consider this to be essential to avoid a "cliff edge" effect for firms, where capital requirements would increase very significantly overnight.

- As drafted, the transitional provisions for exempt CAD firms cover the "Pillar 1" capital rules: the permanent minimum requirement (moving from €50,000 to £75,000), the introduction of the ¼ fixed overheads requirement and K-AUM. We would suggest that as a logical consequence the FCA should also implement **transitional provisions in relation to the ICARA (Pillar 2), liquidity and remuneration requirements** for exempt CAD firms. We look forward to the FCA introducing transitional provisions for these requirements in the next consultation paper. Without these additional transitional provisions, the proposed transitional provisions for ¼ FOR and K-AUM are likely to be of limited assistance to exempt CAD firms in addressing the cliff edge risk of IFPR:

    - The **ICARA** will be new for exempt CAD firms. It requires firms to perform a risk assessment to determine how much capital the firm should hold, including whether this exceeds a firm's Pillar 1 requirement. We understand the FCA's expectation is that the ICARA will identify a level of capital at ¼ FOR or higher. Unless the FCA introduces a transitional provision, this will result in a cliff edge effect for many impacted firms.

    - The **liquidity requirements** will also be new for these firms. As currently drafted, it is likely that the IFPR liquidity requirements would be higher than the own funds requirement under the transitional provisions, further reducing the usefulness of those transitional provisions. Even if the FCA decides to retain the liquidity requirements for exempt CAD firms during the transitional period, those requirements should at least refer to the transitional ¼ FOR only.

- Regarding K-AUM, as noted in our response to DP 20/2, we consider that advice provided by adviser/arrangers to PE/VC fund managers should fall outside the definition of "investment advice of an ongoing nature" in any event. The result is that **the K-AUM requirement will not apply to PE/VC adviser/arranger firms**. Such services may fall outside the definition of MiFID investment advice altogether. Even if such services fall within MiFID advice, they should not be considered "arrangements constituting investment advice of an ongoing nature". The advice given relates to specific potential transactions. It does not involve the sort of ongoing responsibility for monitoring a client's portfolio of the kind contemplated, which role will be performed by the AIFM or portfolio manager which receives the advice. There is generally no "continuous or periodic assessment and monitoring or review". We would welcome guidance to this effect.

- We remain of the view that the introduction of a **¼ FOR for many adviser/arranger firms is disproportionate and unnecessary**. Such requirements are fundamentally out of proportion to the risk that these firms pose. As they have no investment discretion and can relatively easily be replaced by the investment managers that have appointed them, the potential risks to these firms' clients are very limited.

- We remain concerned that **UK firms will in many cases have a more stringent set of requirements than their EEA counterparts** following the introduction of IFD/IFR in the EU.

1.2 Prudential consolidation

- Our view is that **most adviser/arranger firms should not trigger prudential consolidation** is not appropriate for most adviser/arranger firms, given the very limited risk they pose to clients and the market. This is particularly the case where the adviser/arranger acts exclusively as a sub-advisor for fund managers within their group. In those cases, where the affiliate fund manager is established in the UK or EU, it would be more appropriate for the necessary regulatory capital to be held within the manager rather than within the adviser/arranger firm. The rules would otherwise cause a significant amount of overlapping regulation and double counting.

- The proposed **prudential consolidation regime under IFPR is too complex**. As drafted, there remains uncertainty about the intended scope of the consolidation group, particularly arising from the connected undertakings test. While we understand the FCA is somewhat constrained as to the extent it is able to deviate from the EU version of IFPR, we would strongly urge the FCA to consider simplifying the prudential consolidation rules wherever possible.

- We have elaborated on our concerns about **scope and complexity** in more detail in our response to Q4 below, but the key points are:

  - The proposed UK prudential consolidation regime raises interpretational questions about its application to third country firms. We suggest that such firms are brought within scope only to the extent that they carry on investment activities from an **establishment in the UK** (in a similar way to the SNI threshold test). As an alternative, where applying the consolidation rules to an EU firm that is not regulated locally but that would be a MiFID investment firm if it were established in the UK, firms should be allowed to rely on such a firm's local licensing status to determine whether it should be included in the consolidation.

  - We have serious reservations regarding the **complexity and scope of the "connected undertakings" tests**. It is important that the rules do not operate in a way which potentially disadvantages a UK PE/VC fund investing in a UK investment firm compared with a non-UK fund investing in the same asset, for instance by imposing capital requirements on the UK fund. The application of the rules to non-UK headquartered groups is unclear. It should be made clear that the connected undertakings tests do not subject non-UK parent undertakings to the rules. Similarly, global subsidiaries of non-UK parent undertakings should not be consolidated with the UK trigger firms. Any such extraterritoriality would act as a material disincentive to maintaining a UK presence.

  - The definition of "**investment holding company**" in the draft rules is too complex, too broad and could again have unintended consequences for PE/VC groups. We discuss this further in the Appendix.

- We would also welcome some clarifications from the FCA on how prudential consolidation will apply in other contexts beyond the own funds requirements (in particular regarding the **remuneration requirements**). We would request that the FCA address this point in one of its upcoming Consultation Papers. Again it is vital that the UK is clear it is not seeking to impose extra-territorial rules.

1.3 Group Capital Test

- We welcome the proposal to introduce the **Group Capital Test ("GCT") as an alternative to prudential consolidation**. We believe that private equity and venture capital fund manager group structures generally fall within the scope of this discretion and that they should have the option to apply for the discretion to be exercised. However, we still have some material concerns regarding the complexity and lack of clarity in the application of the GCT, as set out in our response to Q6 below.

2. GENERAL COMMENTS ON IFPR

- We remain concerned that there is a material risk of the UK applying the regime in a way which is more onerous than the EU/EEA and that is in practice more onerous than individual member States' application. This would be a very odd result in the context of Brexit. One solution we would propose would be to **appropriately reflect the concept of proportionality**. This would support the rules fitting the wide variety of MiFID investment firms and not placing excessive burdens on firms such as adviser/arrangers.

- We note that the FCA intends to apply IFPR to **a CPMI firm's MiFID activities**. This is in contrast to a number of EU jurisdictions (including Luxembourg as a notable example) that we understand do not intend to apply IFD/IFR to CPMI firms at all. This would put UK CPMI firms at a competitive disadvantage against their EU counterparts, which would have the benefit of both the EU passport and lower capital requirements. The FCA may be restricted in the changes it can make to its approach at this stage, but we would suggest that as a minimum the overlap between the IFPR and AIFMD rules should be reduced as far as possible.

- We do not agree that it makes sense to impose regulatory capital requirements on an advisor/arranger whose sole role is to provide services to a fund manager affiliate beyond a basic requirement of €50,000 (or potentially a higher flat requirement of say €100,000).

- Many UK advisor/arranger firms are regulated as MiFID firms, whereas we understand that equivalent firms established in EU jurisdictions are not. The current impact of this difference is limited by the €50,000 capital requirement imposed on these firms. With the imposition of a ¼ fixed overheads requirement, or an even higher capital requirement under ICARA, that would change materially. In addition, there is no maximum limit on the capital requirements under IFPR, in comparison to the €10 million maximum that exists for the funds under management requirement under AIFMD.

- We would ask the FCA to further explore the possibility of the UK aligning its approach to the EU approach in this respect, to ensure a level playing field between the firms located in the UK and firms located in the EU. The way the regime is implemented in the UK could be regarded as a downside to locating firms in the UK. We are keen to find ways to prevent this from happening wherever possible.

- We also do not think the UK should go beyond the EU IFD/IFR provisions and apply the ICARA or liquidity requirements to SNIs. The ICARA process in particular would be disproportionately burdensome for those firms, and we believe it would be largely unnecessary. Our expectation is that the results of the ICARA process for the vast majority of advisor/arrangers would show that these firms pose very little risk to their clients and to the market.

- More broadly we consider that the UK should keep its implementation of IFPR under review compared to EU implementation, to ensure that the UK's position is not anti-competitive. IFPR introduces considerable additional complexity for firms. This covers the issues referred to above, as well as the definition of "own funds". We don't believe that the additional benefits of these requirements outweigh the compliance costs which are imposed on firms.

We would be happy to discuss the contents of this letter with you; please contact Tim Lewis at tim.lewis@traverssmith.com and Tom Taylor (ttaylor@bvca.co.uk).

Yours sincerely,

Tim Lewis
Chair, BVCA Regulatory Committee

Appendix: BVCA answers to specific questions

Q2. Do you agree with the quantitative thresholds, as set out in Figure 1, that we are proposing? If not, please include in your response what you consider to be suitable quantitative thresholds.

We have no comments on the quantitative thresholds proposed, but we would reiterate our view (as set out in our response to DP 20/2) that that advice provided by adviser/arrangers to PE/VC fund managers should fall outside the definition of "investment advice of an ongoing nature", and so should not be counted within its K-AUM calculations for these purposes. A summary of our reasoning is below:

MiFID investment advice only: We agree with the EBA Consultation Paper on this topic which indicates that the advisory activities of firms which are not MiFID investment advice should not be considered "investment advice" under the IFPR definition of "AUM" or "assets under management" and therefore do not need to be taken into account by firms when calculating K-AUM.

PE/VC advisory services may not be MiFID investment advice: For certain PE/VC arrangements, the related advisory activities may not constitute the investment service of "investment advice" under Section A of Annex I of MiFID as defined in Article 4(1)(4) of MiFID ("MiFID Investment Advice"). This would be the case where such advice will be provided for entrepreneurial purposes and in connection with an industrial strategy rather than a pure financial return and therefore will be corporate finance advice rather than MiFID Investment Advice.

PE/VC advisory services are not "ongoing" advice: Some PE/VC firms will currently be considered to be providing MiFID Investment Advice to the managers of the funds which own portfolio companies. This might be provided on the limited occasions when those funds decide to buy or sell a portfolio company. However, we believe that even in those cases the relevant arrangements are unlikely to constitute "investment advice of an ongoing nature" under the IFPR definition of AUM, and so should not be included in the firm's K-AUM calculations in any event. We understand the purpose of the provisions is to capture non-discretionary investment management. We understand this to cover for example the advisory and execution services of certain wealth managers. These involve the advisory firm reviewing the entirety of a portfolio on an ongoing and continuous basis, making trading recommendations to the client and then (if so instructed), executing the transaction. The nature of monitoring services provided by PE/VC firms is different. It involves working with portfolio companies to support their growth strategies and reporting on this to the fund manager. Monitoring and providing reporting on the performance of portfolio companies should not be considered to be the same as monitoring and reviewing a client portfolio of financial instruments. PE/VC adviser arrangers also advise the fund manager on buying and selling portfolio companies, but this is on an ad hoc basis. Further, fund managers do not allocate a proportion of a fund to a PE/VC adviser arranger firm for ongoing monitoring. Instead, PE/VC adviser arrangers identify ad hoc opportunities and if appropriate, the fund manager may decide to follow the recommendations made to buy or sell.

Q3. **Do you think that any other criteria should be considered for determining if an FCA investment firm can be an SNI? Please provide examples and thresholds as appropriate.**

We welcome the clarification at paragraph 2.11 of the Consultation Paper that, for the purposes of the SNI test, the MiFID activities of a third country firm within an investment firm's group should only be taken into account to the extent that they are carried on in the UK. We would ask the FCA to consider taking a similar approach in the context of prudential consolidation (see our response to Q4 below).

Q4. **Do you have any specific comments on our proposals for the scope and methods of prudential consolidation? Please provide evidence to support any changes. Is there anything relevant to consolidation that is not covered in our rule proposals?**

1. Territorial scope

We welcome the clarification at paragraph 3.8 of the Consultation Paper that only parent companies that are incorporated or have their registered office in the UK will be included for the purposes of the rules on prudential consolidation.

However, we would raise two issues that arise from the statement (at paragraph 3.23) that a non-UK firm should be included in prudential consolidation where, were it established in the UK, it would meet the definition of a relevant entity (e.g. an investment firm). The issue arises in respect of third country regulated firms that either already have their own capital and other prudential requirements or are EU firms which are treated outside of the scope of MiFID in their own jurisdiction but would be treated as investment firms under the UK's wider interpretation of MiFID. Including such firms within a UK IFPR consolidation group is not appropriate. In the case of third country regulated firms, it is likely to cause significant double-counting of own funds and other duplication. In addition, it would be extremely difficult for firms to apply UK prudential rules to activities carried on outside the UK. In the case of EU firms that are treated locally as outside the scope of MiFID, a re-characterisation of their activities according to UK regulation is not appropriate, and would be equally difficult to implement to activities carried on outside the UK.

Our proposed solution would be to follow the approach taken to the application of the SNI thresholds in a group context, as noted in our response to Q3 above. This would entail including only a third country firm's activities from a UK establishment within the scope of prudential consolidation, on a pro rata basis.

An additional measure , in the case of the large number of EU firms that are not regulated locally but would be treated as an investment firm under the UK interpretation of MiFID, would be to allow UK investment firms to rely entirely and exclusively on the local licensing status of the relevant EU firm in carrying out their consolidation analysis, and for such firms to therefore remain outside the IFPR consolidation rules.

These measures would give firms far much needed clarity and certainty in applying the prudential consolidation rules.

2. Connected undertakings and investment holding companies

We have some major concerns with the tests for "connected undertakings" included in the Consultation Paper at paragraph 3.16:

- Complexity: the "connected undertakings" tests are complex. We would suggest that the level of complexity is only suitable for very large firms, such as significant IFPRU firms, rather than being applied more broadly. We understand that these tests were considered for banks but not adopted. The UK should not be adopting more complex tests for MiFID investment firms than it applies to banks. We are concerned in particular about how the FCA expects firms to interpret and apply the tests for being placed under single management and the significant influence.

- Interaction with accounting standards: we note that these tests have been substantially carried over into the UK regime from the EU IFR/IFD, and were in turn adapted from similar concepts in the IAS 28 accounting standards (as described in the EBA Consultation Paper on this topic). We can see the potential merit in aligning regulatory and accounting consolidation, as this could simplify firms' processes. We recommend guidance is added to the Handbook to make clear that this is the intention (if it is the case), and at least guidance noting the derivation from accounting standards.

- Interaction with company law: the "connected undertakings" tests under IFPR as drafted materially broaden the concepts of "unified management" and "significant influence" that already exist under company law and in other regulatory contexts. This could create uncertainty for firms. Again, it would help to indicate the intention to align the new provisions with accounting standards.

- Scope: private equity funds invest in companies in the medium term with a view to growing the value of the company and selling it. Where that company is a UK MiFID firm, it is important that the rules do not operate in a way which potentially disadvantages UK funds making those investments compared with non-UK funds, for instance by imposing capital requirements on the UK funds. If this were to be the effect of the rules, it would (a) discourage UK fund managers from investing in UK financial services and (b) encourage an offshoring of fund structures.

- Interaction with the group capital test ("GCT"): we note that the key issues we have identified above are also relevant to firms wishing to apply the GCT, given the FCA's stated position that the presence of material connected undertakings in a group means it is unlikely to satisfy the requirement of having a "sufficiently simple structure" (see our response to Q6 below).

Our view is that the potential complexity and uncertainty arising from the current drafting would create substantial additional compliance burdens and costs for firms.

We suggest the FCA limit the impact of the "connected undertakings" tests as far as possible, for example by limiting them to significant IFPRU firms, i.e. firms that meet one or more of the following conditions:

- its total assets exceed £530 million;

- its total liabilities exceed £380 million;

- the annual fees and commission income it receives in relation to its regulated activities exceeds £160 million in a 12-month period on a rolling basis;

- the client money that it receives or holds exceeds £425 million; and
- the assets belonging to its clients that it holds in the course of, or connected with, its regulated activities exceed £7.8 billion.

Another solution could be to only require prudential consolidation under the "connected undertakings" test where the FCA has carried out its own analysis and imposed a specific requirement on the relevant firm.

We have similar concerns that the new definition of "investment holding company" in the Glossary to the Handbook is too broad. One limb of that definition is that the relevant entity is a financial institution whose subsidiaries are "exclusively or mainly investment firms or financial institutions". "Mainly" in this context means "more than 50% of the financial institution's equity, consolidated assets, capital deployed, revenues, expenses, personnel or customers are associated with subsidiaries that are investment firms or financial institutions". This test could be highly misleading in some contexts. For example, a group may contain an investment firm which happens to employ a large number of people relative to the other subsidiaries, but the weight of all the other metrics is not associated with investment firms or financial institutions. In such cases it would seem illogical to treat the parent company of the group as an investment holding company. We would suggest replacing the "mainly" test here with a more holistic set of indicators, rather than having any one of the individual metrics as a trigger for an entity to meet the definition of "investment holding company".

3. CPMI firms

We agree with the proposal at paragraph 3.38 of the Consultation Paper that only the MiFID activities of CPMI firms should be included in a group's consolidated situation. We would welcome the FCA taking a similar approach to the other aspects of IFPR for CPMI firms in future Consultation Papers. In particular, it would be logical to apply the ICARA requirements to a CPMI firm's MiFID business only, rather than in respect of the whole of its business (as contemplated in the current drafting of the rules).

More broadly, we understand that the FCA's proposed approach to CPMI firms is more onerous than that which is to be applied in a number of EU jurisdictions (including Luxembourg as a notable example) that do not intend to apply IFD/IFR to CPMI firms at all. This would put UK CPMI firms at a competitive disadvantage against their EU counterparts, which would have the benefit of both the EU passport and lower capital requirements. The FCA may be restricted in the changes it can make to its approach at this stage, but we would suggest that as a minimum the overlap between the IFPR and AIFMD rules should be reduced as far as possible. For instance, we would suggest that CPMI firms should only need to apply the higher of their capital requirements under IFPR or AIFMD, and that the ICARA and prudential consolidation requirements should be disapplied for such firms.

Q6. Do you agree with our approach to the use of the group capital test (as an alternative to prudential consolidation), including our proposal for a transitional provision to allow its use as part of our initial implementation of the IFPR?

In principle we welcome the availability of the GCT as an alternative to prudential consolidation. We believe that a number of PE/VC firms may qualify for the GCT, as their group structures are simple and pose a low risk to clients and the market. However, our view is that the GCT as drafted is too complex for many firms to apply in practice, especially given the issues with the scope of the "connected undertakings" test as described in our response to Q4 above. As with that test, we would encourage the FCA to deviate from the EU version of IFPR and simplify the GCT as far as possible, to make it a workable regime in practice.

We also consider that the FCA's discretion as to whether to grant permission for the GCT is not clearly defined, which is likely to discourage firms from making applications to use it. In particular, we would welcome further clarification on the criteria for a group to be considered to have a "sufficiently simple structure". We disagree with the assertion noted in our response to Q4 above, that the presence of material connected undertakings in a group means it is unlikely to satisfy that requirement.

Q7. Do you agree with the proposals for the definitions and types of, and deductions from, regulatory capital that investment firms should use to calculate their own funds? Do you think that any additional simplification is needed? If yes, please provide suggestions.

We note and agree with the FCA's retention of its current approach to LLP members' capital in this context, allowing it to continue to be used as CET1.

Q15. Do you agree with our proposals for the various transitional provisions relating to own funds requirements? Do you agree that they cover all relevant situations? If not, what specific suggestions do you have?

We welcome the proposed transitional provisions for exempt CAD firms' own funds requirements. It would be logical for the FCA to take a similar approach in relation to the other requirements under IFPR for those firms (including the liquidity, ICARA and remuneration requirements).

In particular, we would note that for many exempt CAD firms, the additional own funds requirements that would arise under the new ICARA process would far outweigh their own funds requirements under the transitional provisions. This would effectively nullify any benefit they would otherwise gain from those provisions. We would ask that the FCA apply a transitional provision delaying the implementation of the ICARA and the other aspects of IFPR for exempt CAD firms for five years, to allow them time to properly consider their approach to the new rules and subject the ICARA document to the necessary level of internal scrutiny.

It is also likely that the liquidity requirements for these firms would be higher than their own funds requirement under the transitional provisions, further reducing the usefulness of those provisions.

We would also welcome similar transitional provisions for CPMI firms, which the FCA has indicated it will consult on in a future Consultation Paper.

Q18. Do you have any comments on the proposal for monitoring and control of concentration risk? Please provide suggestions for any specific clarifications that you feel may be helpful.

We note in this context that many firms within the PE/VCT industry have a very limited number of clients, for example where they act as an adviser-arranger for a single intra-group fund manager client. We wish to clarify that this is a typical arrangement, and does not represent any particular systemic risks from such firms. We also note that for the same reason the concentration risk reporting that the FCA would receive from such firms is unlikely to provide particularly useful data. One potential solution would be to exclude intragroup exposures from the relevant calculations, to give more meaningful results.