European Banking Authority
One Canada Square
Canary Wharf
London E14 5AA
United Kingdom

Submitted electronically

2 February 2017

Dear Sirs,

Re: BVCA response to EBA Discussion Paper on designing a new prudential regime for 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 600 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. Our members have invested over £27 billion in nearly 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 385,000 people and 84% of UK investments in 2015 were directed at small and medium-sized businesses.

We welcome the opportunity to comment on the proposals put forward in the Discussion Paper. Our feedback below follows the representations made by our sister association, Invest Europe, as we have contributed to the pan-European industry response. In addition, we have added further feedback on calibrating the proposals to investment managers managing funds investing in debt.

Executive summary

1. We support the principle of establishing a prudential regime better **tailored to investment firms**, as the current regime was designed for banks. We particularly welcome the proposal to simplify the rules concerning the recognition of items of capital.

2. However, the Discussion Paper gives rise to a number of **material concerns and lacks detail** in places, which means that we cannot confirm our position on whether we can fully support the proposed design of the new regime or whether it would be preferable to retain the existing CRR regime, either in its current form or with modifications.

3. We are concerned that the EBA's proposals, as they are proposed, will catch **a very large number of firms in Class 2**, which should range from systemically important (but bank-like) balance sheet businesses to the smallest private equity adviser firms. By attempting to cover such a large and heterogeneous group in a single regime the EBA risks creating a 'one size fits all' regime which is as complex and inflexible as the regime it is replacing. If the regime is not calibrated correctly, it will lead to an increase in regulatory capital requirements and therefore create barriers for operating in the market, both for existing smaller firms and new entrants alike. This is contrary to the aims of the Capital Markets Union and efforts to encourage investment in European businesses.

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4. The design of the regime should recognise the specific features of the private equity business model (described in Annexes 1 and 2) and set a much **higher threshold for Class 3 firms** also including all firms that are low risk, and appropriately distinguishing between the types of clients services are being provided to.

5. We disagree with the EBA's position on the **purpose of regulatory capital and liquidity** on investment firms which are not bank-like: for these firms the purpose of capital is to facilitate an orderly wind-down, not to ensure the continuity of the firm on a going concern basis or to address contingent legal and regulatory risk. This represents a fundamental change from current practice. Advisory firms are easily substitutable, such that their failure would not prejudice investors in the funds they manage. The same is true of private equity managers. The funds managed or advised are typically closed-ended and this also ensures an orderly transition to another manager/adviser. Furthermore, the nature of the underlying assets of the fund is important – unlisted businesses would still continue to operate. We would strongly encourage the EBA to take these factors into account as part of its cost-benefit analysis and identify the actual risks in the event of the failure of a firm of this type. We also believe that the EBA should not dismiss professional indemnity insurance as an alternative way of covering a firm’s potential liability to customers.

6. We are particularly concerned about the impact of the proposals on investment firms which carry on only the **MiFID investment services of reception and transmission of orders and investment advice** and whose only client is an affiliated private equity fund manager, and which do not hold client money or assets. In our experience there is a divergence of practice across the EU as to whether a private equity business such as this requires a MiFID licence at all. Where a licence is required (as in the UK) such firms are currently subject to an initial capital requirement of EUR 50 000 but under the EBA's proposals would see their capital requirement increase up to the tens of millions of euros just by applying the fixed overheads requirement. We do not believe that this could be justified on cost-benefit grounds for the reasons explained above.

7. We are concerned that the Discussion Paper does not include any quantitative information on the scalars to be applied to the **K-factors**, making it impossible to assess the impact of the proposals in full. Similarly, we are concerned about the ambiguity as to the impact of the proposals on Alternative Investment Fund Managers which have obtained "top-up permissions" under Article 6(4) AIFMD. For these reasons and others, we believe it will be vital that the EBA and/or the European Commission should consult further as this policy develops, including by publishing a full cost-benefit analysis.

8. We do not believe that there is any need to introduce a **liquidity regime** for investment firms which do not conduct “bank-like activities”. We believe that the basic solvency test should ensure that the firm has sufficient liquid assets to meet its liabilities as they fall due. If the EBA considers that an additional liquidity regime is appropriate, then we favour the suggestion that this would be addressed by rules that require best practice in liquidity risk management, rather than any specific quantitative liquidity buffer which in practice leads to cash being held on the balance sheet. This is an inefficient use of a manager’s funds and also a barrier to entry for new funds and it does not take into account the fact that managers will often co-invest in funds alongside their investors.

9. It is important that the regime distinguishes between firms which actively trade with the market from their own balance sheet and those which do not, as the nature of the risks which

could meaningfully be covered by capital differs between the two. The latter category covers asset managers and investment advisors across asset classes.

10. We are concerned that sufficient data on private equity firms would not have been collected by the EBA in 2016. Our membership includes a large number of very small firms which would not have had the bandwidth to engage in the data collection exercise in significant numbers and so we urge caution about the data set being used for calibration purposes.

Detailed response to questions in the Discussion Paper

Question 1: What are your views on the application of the same criteria, as provided for G-SIIs and O-SIIs, for the identification of 'systemic and bank-like' investment firms? What are your views on both qualitative and quantitative indicators or thresholds for 'bank-like' activities, being underwriting on a firm commitment basis and proprietary trading at a very large scale? What aspects of the identification of 'systemic and bank-like' investment firms could be improved?

We support the general approach to defining 'bank-like' activities. The activities identified are those which create balance sheet risk, for which the existing capital regime in CRD/CRR is more appropriate. However, this approach could still leave many investment firms (including some quite large investment firms) which conduct 'bank-like' activities within the new regime for investment firms.

This might exacerbate the difficulties of creating a single prudential regime for investment firms, as the regime will still have to cater for those firms carrying on 'bank-like' activities as well as those, such as conventional and alternative asset managers and advisers, who do not conduct any 'bank-like' activities and assume no, or extremely limited, balance sheet risk. As described further below, the new prudential regime will have to cover a large number of different types of investment firm, and there is a danger that by attempting to cover such a large and heterogeneous group in a single regime the EBA will create a 'one size fits' all regime which is as complex and inflexible as the regime it is replacing.

Question 2: What are your views on the principles for the proposed prudential regime for investment firms?

The EBA initiative provides a good opportunity to establish a prudential framework that is specifically designed to address the nature and the risks of investment firms. If properly done, this should reduce the complexity of the existing rules, which were primarily formulated for the banking industry and which do not appropriately cater for a part of the market that is very different in nature.

However, to achieve this objective, the new regime must be drafted in such a way that it avoids simply increasing regulatory complexity and costs for investment firms that will be subject to the new framework.

Despite the potential scalability of the proposed regime, the EBA approach is likely to impose more complex and higher capital requirements on investment firms than those they are currently subject to, contrary to the EBA's own objective to establish a more proportionate regime for these firms. Private equity firms providing MiFID investment services, which are likely to fall into

the category of non-systemic and non-bank-like investment firms, are among those entities that would, we believe, be adversely affected by the proposed regime.

While we support the broad principle of a separate regime for investment firms, there are aspects of the principles set out in the Discussion Paper with which we do not agree.

1) *General comments*

As can be seen in our description of a private equity structure in Annexes 1 and 2, private equity managers do not carry on 'bank-like' activities and do not assume balance sheet risk. If a private equity manager, even the largest, were to fail this would happen over a long timeframe, as a result of consistently poorly performing investments leading to an inability to raise new funds; existing funds would be wound down as investments in the funds are realised and capital returned to investors. As private equity funds are typically closed-ended vehicles with a long term horizon, the fund would be wound down over a number of years. Management fees would continue to be payable until the funds are wound up (in line with the terms of the contractual arrangement with investors) albeit on a diminishing scale, enabling the private equity fund manager to reduce the scale of its operations as its activity reduced. Even were a private equity fund manager to become insolvent quickly, a replacement fund manager, or advisory firm, would be appointed without there being any risk to the investors in the fund since the insolvency of the *manager* has no impact on the value of any investments held by the *fund*. Furthermore, the nature of the underlying assets of the fund is important – unquoted businesses would still continue to operate.

a) *Purpose of regulatory capital*

We do not agree that the purpose of the new regime should be to address going concern risks. We are concerned with how the principle that the new regime should exist "*to minimise the risk of harm and/or disruption to customers and markets"* is reflected in the proposed K-factors. The principles state that the capital requirements should ensure the continuity of the provision of services. While we agree that it is appropriate for a prudential regime to enable an orderly wind-down, and therefore avoid a sudden loss of service, we do not agree that it should be the purpose of a prudential regime for investment firms (in contrast, perhaps, to a regime applying to the banking sector) to ensure a continuity of service generally. This is particularly the case where such firms are non-systemic and where the value of portfolio company assets would not be adversely affected by the failure of the manager or any adviser. As discussed further below, we think the K-factors seek to address risks to customers which are essentially legal or regulatory liabilities, which it is not appropriate for regulatory capital to address.

While we agree with the general principle that firms which pose greater risk should hold more capital than those which pose less risk, we think the K-factors could, if not sufficiently defined, fail to assess adequately the risks presented by particular types of firms.

The approach outlined in the Discussion Paper, that the greater the scale of activity the higher the risk, is a proxy which is presumably unlikely to capture the actual risks presented by different types of firms and is not sufficiently nuanced. Therefore, further work and consultation is required on the K-factors to ensure that this is not the case.

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b) Firms operating on an agency basis

In point 36 of the Discussion Paper the EBA states that, especially for investment firms operating on an agency basis, "*the most important element of risk will be the potential for harm they may pose to customers*". In light of this, we think a more granular approach should be developed, capturing the type of services these entities offer and to which clients they offer it, with the overall objective of tailoring the prudential treatment to the actual risk posed to the customer.

We acknowledge that taking into account all the specificities of such businesses could be challenging. However, to avoid that hurdle while better addressing the customer risk, it would be useful to reintroduce into the framework some basic categorisation of firms based on their activities. An appropriate and simple level of differentiation could be made between agency businesses, on the one hand, and proprietary trading businesses, on the other.

In order to make it clear and workable, the division could be made based on whether or not a firm is authorised to provide the MiFID investment services of dealing on own account or underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis. Firms which are not engaging in these activities should not be subject to some of the onerous proposals suggested in the Discussion Paper, such as the leveraged-based uplift, to the large exposure limits or to liquidity adequacy rules. This would tailor the regime to the actual risk posed to the customer while maintaining an appropriate level of prudential protection for those firms conducting 'bank-like' activities.

c) Liquidity requirements

We do not believe that there is a need to introduce a specific liquidity regime for investment firms which do not conduct 'bank-like' activities. The liquidity regime in the banking sphere is designed to address the risk of a liquidity or maturity mismatch in liabilities to depositors and counterparties and funding arrangements. Firms that do not conduct 'bank-like' activities are not exposed to the same risks. For these firms, the basic solvency test, requiring that the firm is able to meet its liabilities as they fall due, should ensure the firm has sufficient liquid assets to meet its ordinary course liabilities.

If the EBA considers that an additional liquidity regime is appropriate, then we would favour the suggestion that this be addressed by rules that require best practice in liquidity risk management rather than any specific quantitative liquidity buffer.

2) <u>Private equity firms within the scope of MiFID</u>

As stated by the EBA in its Discussion Paper, MiFID investment firms are a highly heterogeneous group and not all of them share the same business model and do not pose the same risks to their customers and the market. While most private equity firms will not be authorised as MiFID investment firms, the following firms will be caught in the scope of the proposed new regime for investment firms:

(i) Adviser/arranger MiFID firms outside the scope of CRD IV

The vast majority of private equity investment firms will fall in this group (referred to in this response as "*advisers*"). These firms do not hold client money or assets and their MiFID investment activities are limited to the reception and transmission of orders and investment

advice. They assist private equity funds and their managers to invest into companies and may assist third parties to invest in private equity funds. They therefore have a limited number of exclusively professional clients (for example, an adviser firm may only have the manager of the private equity fund as its client, and that manager will usually be another company in the same group as the adviser). We are aware that there are a range of practices across EU Member States as to whether private equity firms of this description need to be authorised under MiFID. In the UK, for example, they are subject to a fixed initial capital requirement of EUR 50 000.

The risk presented by these advisers to customers is very different to the risk to customers identified in the Risk to Customer ("RtC") K-factors. These firms will identify investment opportunities in companies, analyse those opportunities and make recommendations to an investment committee of the manager of the private equity fund(s). The investment committee is separate from the adviser firm, and there is a very high degree of scrutiny and challenge as part of this process. If the adviser firm fails, for whatever reason, to undertake its investment analysis with the required degree of skill and care (and this is not picked up by the investment committee process) then, to the extent this results in a poor investment decision, the fund investors' principal recourse (if any) will be to the private equity fund manager. If the adviser's performance is sufficiently poor, then the fund manager can simply terminate the appointment (although the more likely outcome is that specific individuals within the adviser would be replaced). If the adviser's appointment is terminated the private equity fund manager can simply continue to run the fund without receiving advice, without waiting for or being dependent on any steps in the winding up of the previous adviser. The failure of such an adviser would have no impact on investors or the wider financial market.

(ii) MiFID firms with limited authorisations to provide investment services

These fund managers are structured to have permission to perform portfolio management for the purposes of MIFID but will not have permission for "placing" and will not hold money or assets. They currently fall outside the scope of CRD IV.

They differ significantly from other types of investment firms, as they typically do not deal on own account or underwrite and do not hold client money or assets in connection with investment services.

(iii) AIFMD firms with "top-up" permissions under Article 6(4) AIFMD permitting them to provide limited investment services

Firms authorised under AIFMD can have top-up permissions principally in order to give investment advice and/or to receive and transmit orders in a manner similar to the advisory firms described above. However, in order to be permitted to provide those services under Article 6(4)(b) AIFMD, they must also be permitted to provide the investment service of management of portfolios on a discretionary, client-by-client basis under Article 6(4)(a). Practice varies between EU Member States as to the prudential requirements to which such firms are subject. In at least some Member States, such as France, such firms are required to hold own funds equal to the higher of the requirements under Article 9 AIFMD or under the relevant provisions of CRD III or CRD IV/CRR. It is ambiguous how the EBA's proposals would apply to such firms and we would request further clarity on this point.

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(iv) MiFID firms currently subject to CRD IV requirements

This concerns an extremely limited number of private equity firms which hold a "placing without a firm commitment" permission. We welcome the fact that a new prudential regime specifically for investment firms should end the current situation where firms which have permission to carry on this activity are subject to the CRD/CRR regime. There is no policy rationale for this, since the activity involves no balance sheet risk.

3) *Impact of applying the proposed principles*

While we appreciate the difficulty of drafting common standards for a very wide range of investment firms, including private equity firms, we do not believe that the current categorisation is sufficiently finely-grained to account for the diversity of the businesses that will be in the scope.

As the EBA is reviewing the results from its data collection exercise, the Discussion Paper does not include important detail for firms to fully assess the impact of the proposed regime. In particular, detail on the scalars to be applied to the proposed K-factors is yet to be provided and this is a critical design feature that requires further review. In light of this, we believe it will be crucial for the EBA and/or the European Commission to consult the industry again once it has calculated its initial draft proposed calibrations and clarified the applicability of the suggested K-factors.

Given the proposed threshold for Class 3 firms, the majority of investment firms covered by these proposals are likely to fall within Class 2. Despite the scalability of the K-factor approach, the suggested K-factors to cover the risk of harm to clients in particular, would imply that the regulatory capital would exceed the amount calculated using the Fixed Overhead Requirement ("FOR") (or the proposed new Initial Capital Requirement ("ICR") if that is higher). For firms currently subject to the ICR, such as adviser/arrangers in the UK on a EUR 50 000 requirement, this will lead to a substantial increase in regulatory capital and a potentially duplicative regulatory capital requirement where a sub-advisory relationship exists with an already regulated investment manager.

A considerable increase in regulatory capital requirements (and the need to maintain some or all of this in liquid assets) would create a significant barrier to entry in the market and cause material impediments to both: (a) the provision of equity capital to new and developing businesses and to the economy in general; and (b) innovation and competition in the private equity industry. Furthermore, appropriate transitional and grandfathering arrangements will need to be made if the prudential regime is changed. Finally, it may also be worth mentioning in this context that, in the US, under SEC/FINRA rules, private equity firms are not required to hold a specific level of capital (i.e. there are no net minimum capital requirements)

Question 3: What are your views on the identification and prudential treatment of very small and non-interconnected investment firms ('Class 3')? If, for example, such class was subject to fixed overheads requirements only, what advantages and drawbacks would have introducing such a Class 3? Conversely, what advantages and drawbacks could merging Class 3 with other investment firms under one single prudential regime with 'built-in' proportionality have?

We agree with the EBA approach to give consideration to small and non-interconnected firms and not to base this distinction solely on the size of these investment firms. We do believe, for example, that the level of interconnection of an investment firm with the rest of the market is a

relevant factor to be taken into account in determining the capital requirements a firm should be subject to.

However, we also think that it is important that any quantitative threshold is not set too low – for example, if the "*nano*" threshold is used this is likely to mean that Class 3 will cover only a very small number of firms and that Class 2 firms will therefore comprise a potentially significant population of firms which are non-interconnected.

The AIFM Directive would provide a good benchmark for setting an appropriate threshold. If such an approach – consistent with existing EU law - was taken, a firm could be a Class 3 firm if its AuM/AuA are below €500 million. This threshold would also factor in the legal structure of the fund and the level of leverage employed.

Similarly, given the activity performed is relevant, we would also argue that all firms whose MiFID investment services are confined to reception and transmission of orders and investment advice should also be automatically categorised as Class 3, regardless of their size.

While applying the fixed overhead requirements to these firms would be a possible option, it may be even more appropriate for these firms to be subject to a fixed ICR requiring them to be solvent and to maintain a small margin of capital above that solvency, without necessarily expecting them to maintain further capital to ensure an orderly wind-down given their limited connection with the rest of the capital markets.

When taking into account the level of interconnectivity with the rest of the market and the activities undertaken, the EBA should carefully tailor these two aspects in order to exclude investment firms, such as private equity advisers, which are only connected to one "client" itself separated from the rest of the market.

Private equity fund managers and their advisers, who are making direct investments into real businesses on behalf of their private equity funds have also very limited connections to other participants in the financial system. The fund managers and advisers do not typically borrow at their respective levels, and will not typically undertake any dealing on own account or hold clients' assets/money, and thus have little or no counterparty exposure (and certainly compared to other market participants).

Question 4: What are your views on the criteria discussed above for identifying 'Class 3' investment firms?

In the vast majority of cases, private equity firms with MiFID licences will not carry on any of the activities listed under Question 4 with the exception of being a member of a wider group and using a MiFID passport. However, we have some concerns regarding the following criteria to determine whether a firm can be deemed Class 3: being member of a wider group (point h), the use of a MiFID passport (point i) and the use of tied agents (point j).

Carrying on these activities does not indicate any greater degree of interconnectedness with the financial system. We note that the EBA, in its argumentation set in paragraphs 19 and 20 of the Discussion Paper, assesses that using a MIFID passport and making use of tied agents should not necessarily prevent investment firms from being in Class 3. We agree with the EBA that both activities do not in themselves necessarily matter from a prudential perspective. Indeed, and as

noted in the Discussion Paper, the risk to customers would be no different where a firm operates in a single or several Member States.

We do not consider that membership of a larger group should, of itself, indicate interconnectedness at the solo firm level. Much will depend on the activities and interconnectedness of the rest of the group, as well as the level of interconnectedness of the individual firm within the wider group. If the purpose of the capital regime is to address the risk of the particular firm to customers and the market, it is the activities of that firm which should be considered and not the wider group. The consolidated capital regime which applies where there is a banking group looks at group risks, requiring capital to be held on a group basis in order to address the risks arising out of membership of a group. It does not look at membership of the group in order to determine the solo capital requirements of individual members of the group. Accordingly, we think it would be inappropriate for an investment firm solo prudential requirement to be determined by whether it was a member of a group or not.

Even though private equity fund managers and advisers do not generally hold client money (point a) we do not believe that, in itself, this should be treated as an indication of connectedness either.

We also have a particular concern relating to safeguarding and administering assets (point b). Whilst our members that are MiFID investment firms generally do not provide the MiFID ancillary service of custody, certain private equity AIFMs do safeguard and administer assets as part of their AIFM management activity. Specifically, title to shares in private unlisted companies held beneficially by the private equity fund may be registered in the name of a nominee company controlled by the private equity manager, and physical documents evidencing title (such as share and loan note certificates) may be held by the private equity manager. In neither case is there any substantive risk of loss of "title" since the assets typically represent a control position in an operating group of companies. For this reason, we do not believe that safeguarding and administering assets should always disqualify a firm from a lighter prudential treatment.

Question 5. Do you have any comments on the approach focusing on risk to customers (RtC), risk to markets (RtM) and risk to firm (RtF)?
Question 6. What are your views on the initial K-factors identified? For example, should there be separate K-factors for client money and financial instruments belonging to clients? And should there be an RtM for securitisation risk-retentions? Do you have any suggestions for additional K-factors that can be both easily observable and risk sensitive?

For the purpose of this Question, we have examined the relevance of the different K-factors for the private equity firms/advisers which are providing some MiFID investment services.

Risk to customers

In its Discussion Paper the EBA states that the "*most important element of risk will be the potential for harm they may pose to their customers*". It then suggests to look at the activities and the amount of assets under management by the investment firm as a proxy for the risk created by incorrect discretionary management of portfolio or poor execution. The volume of assets managed or under advice by an investment firm would therefore be used as a metric for the risk the firm poses to the customer. The proposal also does not distinguish between services provided to professional and retail clients. For the reasons set out below, this approach is unlikely to work

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in all contexts and may, depending on how the K-factors are defined, be particularly problematic for private equity advisers who are regulated under MiFID.

It is very difficult to assess the exact impact of the K-factors on individual firms, given the absence of detail in the Discussion Paper. However, we are concerned that the basis for the new prudential regime suggested in the Paper requires capital to be held against risks which are not best addressed by capital and which will essentially require firms to hold capital against going concern risks. The RtC K-factors (AUM, AUA, ASA and CMH), in particular, are intended to require capital to be held against customer risk. The type of customer risk referred to in the Paper appears to be failures that might give rise to legal or regulatory liability by the firm to its customers:

"*36. For the vast majority of investment firms, especially those which operate on an agency basis, the most important element of risk will be the potential for harm they may pose to their customers (for example, where they do not carry out the relevant investment services correctly)."*

The K-factors are a proxy for that customer risk, and assume that the larger the firm's business (measured in AUM, AUA, ASA or CMH) the greater the risk posed and the higher the capital requirement that will be imposed. We believe this approach has a number of flaws.

First, it is not appropriate to require capital to be held to address contingent, legal and regulatory risk to customers arising out of negligence or breach by the firm. These risks are generally going concern risks which, as the EBA itself recognises in its December 2015 Report are not the objective of the prudential regime for most investment firms. The EBA Paper states:

"86. (…) *At the same time it seems worth discussing to which extent the permanence of capital is needed to ensure prudential concerns are met given that the EBA Report states that the concept of ensuring going concern is not essential for the majority of investment firms as opposed to caring for the impacts of withdrawal of the firm from the market.*"

These risks are much more appropriately addressed by professional indemnity insurance ("PII"), and we consider that the EBA should not dismiss PII as an alternative way of covering a firm's potential liability to customers. If, as we believe to be the case for non-systemic firms, the objective of the prudential regime should be to ensure an orderly wind-down of the investment firm there is no reason to think that the amount of assets under advice or assets under management would be a good proxy for the costs of an orderly wind-down, as these are unlikely to increase proportionally to the size of assets under advice or management.

Second, it does not necessarily follow that the size of a firm's business, measured in AUM or AUA, for example, is a good proxy for the sort or customer risk identified in the Paper. A larger, better-resourced firm may have more extensive systems and controls to prevent failings or breaches, and so it may present a lower customer risk than a firm with fewer customers but a much less-detailed control environment.

Third, unless they are properly and clearly defined, the K-factors could result in all firms carrying out the same broad activity being treated as presenting the same risk to customers. For example, the risk presented by a firm which has a very small number of professional advisory clients (as is the case for most private equity advisers) is quite different to the risk presented by a firm which has a large number of retail advisory clients. Unless the K-factors are properly defined the firm

with a small number of professional clients might end up with a higher capital requirement than the firm with a large number of retail clients, simply because it has more AUM or AUA.

Furthermore, the EBA Paper indicates that the AUA K-factor is intended to capture "*investment advice provided on an ongoing basis*" where the "*advice being given will be simply accepted, without question, which therefore is similar as if the firm had a discretionary power. It would not, however, capture the customer taking 'one-off' advice on a transaction.*" As stated above, private equity advisers will typically provide their investment recommendation to an investment committee, which will subject the recommendation to significant challenge and scrutiny. We consider that it will be very important that the approach on investment advice provided in paragraph 37, point b of the Discussion Paper is clearly reflected when the detailed proposals are published. The MiFID service of investment advice is wider than advice given on an ongoing basis where the customer is likely simply to accept the advice without question. So a K-factor based solely on whether a firm conducts investment advice, without further defining the nature of the advice and the recipient, is likely to require firms to hold capital against risks to customers which their particular investment advice does not present.

Although MiFID advisory firms may be allowed to provide investment advice to a range of different clients, the private equity advisers we represent will typically only provide their advice to the manager of the private equity fund. This manager will be part of the same structure, as shown in Annexes 1 and 2 attached to our response. Therefore, these firms will differ significantly from other types of MiFID advisory firms as they generally offer advisory services to only one professional client and, in some cases, to a limited number of professional clients who are investors into the fund.

For the reasons outlined above, we do not agree that the amount of AUM or AUA are, in all circumstances, necessarily good indicators of the risk posed by an investment firm, particularly in a private equity context. The nature of the advice being provided and the number and type of clients the services are being provided to are more relevant factors in that context.

Finally, we believe that great care should be taken in calibrating the ASA K-factor. Not all types of custody present the same risks. As explained above, our members that are MiFID investment firms generally provide the MiFID ancillary service of custody. However, certain private equity AIFMs do safeguard and administer assets as part of their AIFM management activity. Specifically, title to shares in private, unlisted companies held beneficially by the private equity fund may be registered in the name of a nominee company controlled by the private equity manager, and physical documents evidencing title (such as share and loan note certificates) may be held by the private equity manager. In neither case is there any substantive risk of loss of "title" since the assets typically represent a control position in an operating group of companies. For this reason, the ASA K-factor should be calibrated with care, taking into account the differing interpretations between EU Member States as to what amounts to "custody".

<u>Risk to Market</u>

The impact a MiFID private equity firm can have on the market in which it operates will be at best minimal. These managers and advisers do not engage in proprietary trading, do not deal on own account and do not take deposits. The private equity fund manager or adviser is not a counterparty to any investment transaction; investments are made by the separately constituted fund, whose investment capital belongs to its investors.

Where a private equity fund manager or adviser becomes insolvent, there would typically be no impact on the portfolio companies which the fund owns, nor on any other fund, nor on the wider financial services market. The impact on the fund would be that it would need to appoint a new manager or adviser, i.e. the investors or manager would need to find a replacement manager or adviser for the fund. This is a totally different order of magnitude from the risk posed by banks and perhaps by other MiFID investment firms.

If the adviser is the only one to fail, the manager would remain in place and continue to take decisions and deal for the fund. There would therefore be absolutely no risk to the market in this case.

It is also worth noting that the type of investments, and investment decisions, made in the private equity sector involve a lower level of risk for the wider markets and economy in the event of failure of the manager. The funds they manage generally do not hold significant positions on the public markets or in derivatives or need to trade actively in order to maintain the value of the portfolio (indeed they are not really intended not to be traded at all). Instead, each portfolio company in which the fund invests will have its own management and employees able to operate on a standalone basis in that part of economy in which they operate. The private equity fund is not exposed to settlement risk on the private transactions they enter into, as these do not use DvP/RvP/free of payment settlement mechanics. As the shares are not capable of being actively traded, if there is an error in a transfer, it is not possible for a third party to benefit from the error at the expense of the private equity fund. This means private equity funds are not exposed to the risks of settlement in the same way that a fund trading listed securities would be.

The above arguments are equally applicable to fund managers. We note that one distinguishing factor is that certain debt fund managers are required to invest in funds which they manage in order to offer those funds to EEA banks and insurers. This applies where the fund is classified as a securitisation and the manager holds notes in a securitisation as sponsor under the EU's securitisation risk retention requirements. We do not consider that there should be a specific RtM K-factor in relation to these securitisation risk retentions. Where a sponsor holds a securitisation risk retention, the relevant notes issued by the securitisation are no different from any other asset held on the firm's balance sheet. These assets are held for the medium to long term and not for trading purposes. In our view, it is neither necessary nor appropriate to design a specific metric and scalar in relation to such assets. The key issue is that the manager is required to maintain the relevant exposure for risk alignment purposes.

Relationship between the K factors

We would like to point out that there is also a risk of double-counting between the K-factors, in case an advisory firm executed an order following an advice it had given. This will need to be taken account by the EBA while drafting its final prudential regime. The risk of double counting is that, for example, AIFMD will require the AIFM to hold capital based on assets under management. It is double counting to require a sub-adviser or sub-manager to also hold capital based on assets under management or advice where the risk to customer is already addressed by the capital held by the AIFM.

Question 7: Is the proposed risk to firm 'up-lift' measure an appropriate way to address the indirect impact of the exposure risk a firm poses to customers and markets? If not, what alternative approach to addressing risk to firm (RtF) would you suggest?

We do not consider that an RtF uplift factor is necessary for MiFID investment firms amongst our membership. Assuming they are adequately defined and calibrated, the RtC and RtM K-factors ought to address all relevant risks.

The proposed definition of leverage taken from CRR, is in our view a poor proxy for the risk to the firm. The main risk with the EBA approach is to create an entirely artificial uplift based on the amount of debt on the balance sheet of the firm, irrespective of how this debt is used and of the internal structure of the firm.

We note that the EBA suggests in its Discussion Paper for the uplift factor not to be applied to investment firms below a certain size, based on their ICR times a multiple ("*y*") to be determined. We are of view that the proper calibration for this smoothing factor would require the proposed multiple to be equivalent to at least hundreds of the ICR.

Further to the proposed quantitative threshold, we also suggest the uplift factors should only apply to firms which are not posing significant risk to customers. As stated in Question 2, we believe that firms which are neither dealing on own account nor underwriting should always be exempt from applying the uplift factor when calculating their capital requirements.

Question 9: Should a fixed overhead requirement (FOR) remain part of the capital regime? If so, how could it be improved?

As a general proposition, we consider that there is a place for the FOR to remain part of the capital regime. As mentioned in other parts of our response, we consider that the purpose of the prudential regime for investment firms should be to ensure an orderly wind-down. As such, the FOR is consistent with this objective and the straightforwardness of a simple FOR regime could have potential benefits for some investment firms as long as it is proportionate to their risk and the amount of time they require to wind-down.

However, we also consider that the FOR might be completely inappropriate for certain type of firms and could result in private equity firms having to hold much more capital than is strictly necessary in order to ensure an orderly wind-down.

For example, the EBA should not rule out applying the CRR regime to sub-advisory businesses which have no impact on clients and therefore this regime would be more appropriate than the FOR as such firms do not require to hold any capital for a wind-down. If the FOR was applied to these firms, they would be forced to hold large amounts of capital without real benefits from a prudential point of view.

At the moment, investment firms which only provide certain types of MiFID services, such as limited investment advice, are subject to a fixed initial capital requirement. We believe that there were good reasons for originally imposing a simple flat rate regulatory capital requirement on such firms, requiring them to continue not only to be solvent but also, unlike other private undertakings, to maintain a small margin of capital above that solvency, without expecting them to maintain further capital to ensure an orderly wind down.

As a result, private equity advisers will typically be subject to capital requirements from EUR 50 000 to 125 000 depending on the Member States in which they are based. If the proposed FOR were to be applied, they would be subject to capital requirements up to 200 times greater in the case of the larger firms.

Given how long the existing regime has been in place, including during the recent credit crisis, there is sufficient evidence for the EBA to consider whether the existing regime has given rise to any problems in practice which would require an increase to the existing basic requirement. We are not aware of any such problems arising, even during the financial crisis. There is therefore no evidence that a significant increase of the capital requirements of these advisers would be necessary.

Applying fixed overhead requirements will not be the best approach based on the risk that the failure of a private equity adviser would pose. Indeed, and as explained in our response to the "risk to market" part of Question 5, the customer risk – meaning the risk for the manager - would be very limited given the manager would simply have to appoint a new adviser in case of a failure of the adviser. Meanwhile, the creditor risk will not be different from other types of private businesses outside the financial sector.

It is also important to stress that the likelihood of failure of a private equity adviser is small. Once a fund has been raised, the management fee determined at the outset of the fund with its investors will provide for a stable and visible source of revenue and will allow the manager and the adviser to plan for their operating expenses during the life of the fund. Nevertheless, we accept that the absolute amount of the initial capital requirement may need to be adjusted to take account of inflation since the original rules were introduced.

Question 12: Does the definition of capital in the CRR appropriately cater for all the cases of investment firms that are not joint stock companies (such as partnerships, LLPs and sole-traders)?

Question 13. Are the cases described above a real concern for the investment firms? How can those aspects be addressed while properly safeguarding applicable objectives of the permanence principle?

Question 14. What are your views on whether or not simplification in the range of items that qualify as regulatory capital and how the different 'tiers' of capital operate for investment firms would be appropriate? If so, how could this be achieved?

Question 15. In the context of deductions and prudential filters, in which areas is it possible to simplify the current CRR approach, whilst maintaining the same level of quality in the capital definition?

Question 16. What are your views overall on the options for the best way forward for the definition and quality of capital for investment firms?

We are of the view that the definition and quality of capital used in CRR is not always appropriate for investment firms given the different types of legal structures in use, such as limited liability partnerships and limited partnerships. Applying rules designed for banks creates significantly complexity for members or partners in such firms and requires additional advice to be sought to ensure appropriate arrangements are in place from a legal and regulatory perspective. Such arrangements may not be commercial or practical from an operational perspective.

We also welcome the suggestion that the definition of capital might be appropriately tailored to reduce the emphasis on permanence of capital. These requirements in CRD/CRR are complex to apply in the context of partnership and limited liability partnership capital regimes, and result in

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capital becoming 'trapped' in the investment firm even where the actual capital requirement has reduced and the capital in the firm represents a significant surplus over the capital requirement.

Question 17. What are your views on the definition of initial capital and the potential for simplification? To what extent should the definition of initial capital be aligned with that of regulatory capital used for meeting capital requirements?

Question 18. What aspects should be taken into account when requiring different levels of initial capital for different firms? Is there any undesirable consequence or incentive that should be considered?

We welcome the potential for simplification and additional harmonisation of the definitions of initial and regulatory capital. We also understand the EBA position set in paragraph 105 of the Discussion Paper that existing thresholds need to be adjusted to take into account inflation.

However, it is important this increase remains proportionate, in line with our comments on Question 9.

Question 19. What are your views on whether there is a need to have a separate concept of eligible capital or whether there is a potential for simplification through aligning this concept with the definition of regulatory capital used for meeting capital requirements?

We agree that it should not be necessary to have a separate concept of eligible capital and support simplification with a unified definition based on the definition of own funds.

Question 20. What is your view on whether holding an amount of liquid assets set by reference firms? If so, how could that stress be defined?

Question 21. What is your view on whether holding an amount of liquid assets set by reference to a percentage of the amount of obligations reflected in regulatory capital requirements such as the FOR would provide an appropriate basis and floor for liquidity requirements for 'non-systemic' investment firms? More specifically, could you provide any evidence or counter-examples where holding an amount of liquid assets equivalent to a percentage of the FOR may not provide an appropriate basis for a liquidity regime for very small and 'non-interconnected' investment firms?

Question 22. What types of items do you think should count as liquid assets to meet any regulatory liquidity requirements, and why? (Please refer to Annex 4 for some considerations in determining what may be a liquid asset).

Question 23. Could you provide your views on the need to support a minimum liquidity standard for investment firms with the ability for competent authorities to apply "supplementary" qualitative requirements to individual firms, where justified by the risk of the firm's business?

Question 24. Do you have any comment on the need for additional operational requirements for liquidity risk management, which would be applied according to the individual nature, scale and complexity of the investment firm's business?

We would advise the EBA to avoid introducing a specific liquidity regime for investment firms which do not conduct "bank-like activities".

For private equity managers and advisers, any liquidity regime should focus on ensuring best practice in liquidity risk management to meet the basic requirement that the firm is able to meet its liabilities as they fall due. The risks posed by those firms are limited due to the predictable and controllable nature of cash inflows. Receivables may relate to income from an affiliated entity or a fund/account managed by the firm. Furthermore, liabilities relate to amounts due to employees, partners in the firm, suppliers and other service providers. These are all predictable cash outflows and do not create risk in the wider financial markets.

We disagree with the suggestion to link the amount of liquid assets required to the obligations reflected in regulatory requirements. We have found the approach already in place under AIFMD (to hold regulatory capital in cash or highly liquid assets) to be disproportionate as it requires firms to lock up large amounts of cash for a long time and is an inefficient use of capital. Not only is this a significant barrier to entry for new firms/start-ups, it takes no account of the fact that individuals in such firms will often have invested in the funds managed to ensure there is an alignment of interest with investors ("skin in the game"). We also do not support the approach for a liquidity buffer as this would be difficult to calculate and would not be risk-focussed.

Question 25. What are your views on the relevance of large exposures risk to investment firms? Do you consider that a basic reporting scheme for identifying concentration risk would be appropriate for some investment firms, including Class 3 firms?

In the context of private equity fund management, large exposures are usually represented by either intra-group receivables or fees owed to the firm by a fund which is managed and operated by the firm or by another member of its group. The Committee of European Banking Supervisors published a consultation paper in December 2007 in which it noted that investment management firms did not represent a significant risk of contagion, and concluded that the application of the large exposures regime to investment managers might be an example of regulatory failure since the regime imposed a burden on investment firms (including a reporting burden) without delivering benefits to consumers. We respectfully agree with CEBS' conclusions and argue strongly against any additional rules or the reintroduction of reporting requirements in this area for asset managers in either Class 2 or Class 3.

An appropriate way for the EBA to assess firms for which large exposures risk would not be relevant is to look at which activities they carry, and in particular whether they are dealing on own account or engaging in underwriting activities. Our view is that specific concentration rules wold not be appropriate for firms which do not conduct such activities.

Question 29. What examples do you have of any excessive burden for investment firms arising from the current regulatory reporting regime?

We support the idea of reporting tailored to the features of investment firms, as opposed to banks.

Question 30. What are your views on the need for any other prudential tools as part of the new prudential regime for investment firms? And if required, how could they be made more

appropriate? In particular, is there a need for requirements on public disclosure of prudential information? And what about recovery and resolution?

We do not see any need for additional prudential tools. In particular, we do not consider private equity firms to be systemic. There is therefore little justification to apply a recovery and resolution regime.

Since the issue of consolidated supervision/consolidated capital requirements is not raised elsewhere in the EBA's questions, we wish here to express our view that a solo capital regime ought to be sufficient for our members. Having appropriate solo capital requirements for investment firms, which are designed to ensure an orderly wind-down, should be sufficient tools.

Question 33. What is your view on a prudential remuneration framework for other than 'systemic and bank-like' investment firms that should mainly aim to counteract against conduct related operational risks and would aim at the protection of consumers?

It is perfectly legitimate to apply remuneration rules that were developed with a particular part of the financial services industry in mind and take into account its specific features and characteristics. However, we do not believe that this ought to be a prudential remuneration framework (since this implies risk to the balance sheet of the firm which is not the key consideration), but rather a remuneration framework focussing on conduct of business and the alignment of interests between a fund manager and investors.

For example, private equity managers employ alignment of interest and incentive structures, in particular carried interest and co-investment based arrangements, which are specifically designed to align the interests of investors with fund managers and their executives / "identified staff" in order to avoid excessive risk-taking[1].
Carried interest is an agreed percentage of the cash profits of the fund. It will be paid out to the manager and subsequently to its executives who participate in the carried interest arrangements only once the external investors have received back all of their drawn down capital (including typically also amounts drawn to pay the management fee) plus an agreed preferred return. Carried interest is generally regarded as the main incentive to the fund manager and is a key mechanism for aligning the interest of the fund manager and investors.

There is no better, more considered or aligned remuneration structure for the private equity industry and private equity managers and their executives / "identified staff" should be able to continue to apply these sector-specific remuneration rules.

Question 34. What are your views on having a separate prudential regime for investment firms? Alternatively, should the CRR be amended instead to take into account a higher degree of proportionality? Which type of investment firms, if any, apart from systemic and bank-like investment firms, would be better suited under a simplified CRR regime?

[1] For further details, please refer to our response to the ESMA Consultation Paper: "Guidelines on sound remuneration policies under the UCITS Directive and AIFMD: https://www.investeurope.eu/media/420568/ESMA_UCITS_V_AIFMD_REMUNERATION_Invest-Europe_RESPONSE_231015.pdf

As we mentioned in our response to Question 2, we welcome the idea of a separate prudential regime provided it is sufficiently tailored and recognises the specificities of the investment firms caught within its scope.

We would like to stress again that, while some of the EBA suggestions have the potential to streamline requirements imposed to investment firms, they also risk increasing significantly the amount of required capital for many private equity advisers, without considering the risk they pose to their customers and to the market.

At the same time, the option of an amendment to CRR should therefore not be completely excluded if it is the view of the EBA that rules would be better tailored to MiFID firms within the CRR framework. Most importantly, the future framework should focus on actual operational risks as it is likely to be the primary risk to our members when they provide MiFID investment services that do not deal on own account, take deposits or hold client money. It should ensure that appropriate consideration is given to the assessment and oversight of this risk.

We would be very keen to discuss the contents of this letter further with you and please contact Gurpreet Manku (gmanku@bvca.co.uk) at the BVCA to arrange a meeting.

Yours sincerely,

Tim Lewis
Chair, BVCA Regulatory Committee

Annex 1- Explanation of a typical private equity fund structure

Basic structure

A private equity group is typically small – 84% of funds that reached a final closing in 2015 had raised less than € 500 million, 50% having raised less than €100 million - and is typically established and owned by its key executives. Some private equity groups (particularly in the US) have grown to be much larger and have themselves listed some of their equity on public markets, but this is the exception.

A private equity fund structured as a limited partnership is created through negotiation between investors (also known as "limited partners") and their legal advisers and the private equity manager (also known as the "general partner"). This results in a governing document (for example, the limited partnership agreement) that sets out the key terms of the fund. The private equity group owns the general partner (one of the partners in the fund) and the fund manager, which manages the fund. In some cases, the general partner and fund manager are a single legal entity.

Investors make commitments to invest in the fund, i.e. the amount they originally agree to subscribe to the fund. The amount committed is not paid immediately on a fund's closing but in tranches over the commitment period on an "as needed basis" (typically four to seven years).

Pursuant to the constitutional documents of the fund, the private equity group receives a fixed annual amount for managing the fund. This is often structured as a fee charged by the fund manager to the general partner, who pays the fee out of its priority profit share received from the fund ("PPS" or "management fee"). Any increase in risks and the valuation of the fund does not increase the amount of management fee, so there is no incentive to increase these risks. Private equity managers must therefore carefully budget to ensure their cost base is covered by the PPS.

The PPS/management fee is intended to cover the overheads of the general partner and fund manager, including e.g. salaries, office rents, etc.

Investments

The fund invests in a number of unlisted portfolio company operating groups, typically aiming for a measure of diversification by geography, sector etc. Examples of private equity-backed companies include Hugo Boss, LM Wind Power, Ducati, Materne or Arena.

In many cases, the fund will take a controlling position in the equity of the holding company (but this varies between private equity and venture capital strategies). Members of the management team of the portfolio company will often also have a shareholding, in order to incentivise them.

Third party banks may lend to each portfolio company group.

There is typically no cross-collateralisation or exposures as between one portfolio company group and any of the others. Each investment is in its own silo, separated from the others.

Fund profitability

Profits are achieved by the fund only on a successful realisation of the fund's investments, which might arise on the sale of the portfolio company or following proceeds received as a result of its initial public offering on a listed market. Fund profits for the purpose of paying out distributions are therefore realised and real (as opposed to being based on accounting valuations). Typically, proceeds received by a fund are distributed in a timely fashion to investors and are not held within the fund pending a fixed distribution date sometime in the future.

As each of the fund's investments are profitably realised, once any outstanding fees and expenses

of the fund have been paid, investors are first repaid all the money drawn down from them in full, plus the agreed preferred return. Only then is the agreed percentage of any generated profits of the fund paid-out in carried interest to the manager and its executives.

Carried interest

Carried interest is a basic element in private equity fund structures. The detailed terms of a particular fund's carried interest structure are agreed by the investors and fund managers and set out in the fund's constitution document. The investors are almost universally institutional (professional) investors, who are highly experienced and well advised. To ensure alignment with their interests, investors expect key members of the investment team at the private equity group to be part of the carried interest based arrangements. They typically also expect to see a co-investment obligation from these team members. Commercially, investors would prefer to see the firm founders allocate as much personal wealth as is available to co-investment, as opposed to allocating that wealth to regulatory capital in the manager or its group.

Investors must receive back from the fund in cash an amount equal to their drawn down commitments (the amounts they actually pay in to the fund at the time the distribution is being made) plus a preferred return on this amount (currently, typically 8% p.a.). Only then does the carried interest vehicle start to participate in a percentage of the profits. After this preferred return has been reached, profits are allocated in accordance with a pre-determined formula agreed with investors and set out in the fund constitutional documents. In other words, carried interest operates on a cash to cash (realised profits only) basis. It does not pay out based on accounting valuations.

Co-investment

Co-investment by private equity executives may be negotiated between investors and the manager to promote alignment of investor interests and to ensure that the investment team has "skin-in-the-game" alongside investors. In other words, they put at risk the loss of their own money through their stake.

There is no common method by which the co-investment is funded. It will depend on the particular circumstances of the prospective participants and the level of the commitment.

What would happen in the event of failure of one or more entities?

In the event of failure of a portfolio company group, any lending bank may exercise security and take control. There is no impact on the other portfolio companies. Investors hope that the fund will not lose money overall but understand the risk of loss of capital.

It is very rare for the fund to become insolvent, but an insolvent fund would be liquidated. The manager would lose its management fee and investors would suffer loss of capital.

In the event of failure of the management company, or general partner, the investors would between them agree on the appointment of a replacement general partner and/or manager. There are numerous firms in the market who would be prepared to take on such a mandate. In the meantime, each portfolio company group would continue to operate as normal under the control of its own separate management.

In the event of failure of an adviser, there would be no material impact on the fund, the general partner or the manager, though the general partner / manager may choose to appoint a different firm to advise it.

Annex 2 – Example of a private equity fund legal structure

Note: *The diagram below is illustrative only and not all firms operate in the same way*