29th May 2015

Mr Tom Ward
Strategy and Competition Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London, E14 5HS

By email: dp15-03@fca.org.uk

Dear Mr Ward,

Re: DP 15/3 – Developing our approach to implementing MIFID II conduct of business and organisational requirements

Introduction

This response to the FCA's Discussion Paper entitled 'Developing our approach to implementing MIFID II conduct of business and organisational requirements' (DP15/3) is made by the Regulatory Committee of the British Private Equity and Venture Capital Association (the "**BVCA**"). The BVCA welcomes the FCA's engagement with stakeholders on this important issue.

The BVCA and the UK Private Equity ("PE")/Venture Capital ("VC") industry

The BVCA is the industry body for the UK PE/VC industry. With a membership of over 500 firms, the BVCA represents the vast majority of all UK-based PE/VC firms and their advisers. Its members have invested around £30bn into nearly 4,000 companies based in the UK over the last five years. In 2013, around £4.1bn was invested into around 710 UK companies. Of the total number of companies invested in during 2013, around 64% were small companies, while 22% were medium-sized companies ("**SMEs**").

Our response

We set out below answers to the Discussion Paper's questions which we consider are of particular relevance to the UK PE/VC industry. We would be happy to expand upon any of the points raised in our response if the FCA would find it helpful. If the FCA would like us to do so, we would ask that it contacts Gurpreet Manku (Director of Technical and Regulatory Affairs, BVCA (gmanku@bvca.co.uk)) in the first instance.

Yours sincerely,

Sheenagh Egan
Chair - BVCA Regulatory Committee

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FCA Discussion Paper: Developing our approach to implementing MIFID II conduct of business and organisational requirements

The immediate impact of MiFID II for PE/VC firms operating in the UK will vary depending on the firm's structure and regulatory status. Some are MiFID investment firms – many are exempt-CAD firms, others are BIPRU or IFPRU limited licence firms or CPMI firms. These firms will be directly affected by the regulatory changes introduced by MiFID II. Others are not MiFID investment firms – those authorised as full-scope AIFMs without additional MiFID 'top-up' permissions, and those authorised as small UK AIFMs or residual CIS operators subject to the UK's domestic regulatory regime. These firms will not be directly affected by MiFID II, but may be indirectly affected, especially if the FCA proceeds with its proposal to 'level-up' requirements for consistency.

In this response, we have not addressed all the questions raised in DP15/3, but have sought to highlight the three issues most likely to affect PE/VC firms operating in the UK. As a general comment, we do not support the 'levelling-up' of requirements for reasons of consistency if there is otherwise no clear policy reason to do so. In our view, this approach would be in direct conflict with HM Government's 2013 "*Guiding Principles for EU Legislation*"[1], the first line of which states: "*These are the guiding principles underlying the Government's approach to EU Measures, aimed at maximising the UK's influence in Brussels and ending the gold plating of EU legislation in the UK [emphasis added].*"

We are particularly concerned about the potential impact of such an approach on sub-threshold AIFMs, which are typically smaller firms investing in the real economy. We believe that 'levelling-up' is likely to result in a disproportionate and unnecessary burden being imposed on such firms, particularly when compared with their peers in other EU Member States.

Chapter 5. Professional client business – client categorisation and treatment of local public authorities and municipalities

Q9: Do you agree with our approach to re-categorise local authorities undertaking non-MiFID business as retail clients, with the option to opt up to elective professional client status? Do you agree that that the opt-up criteria for local authorities should follow our existing approach with respect to non-MiFID business?

Q10: Do you agree with the approach set out in option A and the possibility of providing guidance on the qualitative test? If so, please explain what sort of guidance you think would be useful. Please provide any evidence to support your views.

Q11: Do you agree with the approach set out in option B? Please provide your comments and any evidence to support your views.

Q12: Do you agree with the approach set out in option C? Please provide your comments and any evidence to support your views.

[1] Department for Business, Innovation & Skills (2013) Guiding principles for EU legislation - https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/185626/bis-13-774-guiding-principles-for-eu-legislation.pdf

Local authority pension funds ("**LAPF**") are significant investors into PE/VC funds. External data provided by the research provider 'Preqin' indicates that over 60 UK LAPFs invest into PE funds as part of a diversified investment portfolio with over £13bn in aggregate currently allocated to PE investments. PE/VC generally forms a small part of any individual LAPF's portfolio (typically between 4% and 10%), but the aggregate investment is significant.

The ability to select from a wide variety of PE/VC funds facilitates diversification of LAPF portfolios outside of bonds and listed equities. We therefore believe it is important that the pending changes to the categorisation of local authorities do not restrict LAPFs from accessing PE/VC funds, to the extent they are considered to be retail clients for these purposes.

If it were not possible to treat LAPFs as professional clients, there is a risk PE and VC firms would be deterred from engaging with LAPFs as retail clients and as a result effectively turn away from this source of capital for their funds. The likelihood of this increases considerably for medium and larger PE funds where LAPF commitments may make up a relatively small proportion of an overall fund and the additional risk and administrative cost of marketing to a small number of retail clients cannot be justified. Re-categorisation without a workable 'opt-up' regime could therefore have the unintended consequence of 'closing the door' to this higher performing asset class for LAPF investors.

Categorisation of LAPF investors

LAPFs following a long-term investment strategy are equivalent to private sector pension schemes (which are treated as *per se* professional clients). We believe it is appropriate from a policy perspective that LAPFs should be treated as professional investors; they are different in nature to a local authority's treasury management function and the same policy considerations do not apply. A difference in treatment between LAPFs and private sector pension schemes will create an unlevel playing field that disadvantages LAPFs as investors.

We would ask the FCA to consider whether it is possible for firms to treat LAPFs subject to the Local Government Pension Scheme Regulations 2013 as *per se* professional clients on the basis that they are: (i) pension funds that are regulated (under those regulations, without reference to a Directive) to operate in the financial markets; and/or (ii) other institutional investors whose main activity is to invest in financial instruments. If so, it would be helpful if the FCA could confirm that this is the position even if the LAPF is not a separate entity from its associated local authority.

Non-MiFID Business

In most cases, PE/VC firms will be engaging with LAPFs in circumstances that do not constitute MiFID business. Hence, the non-MiFID business client categorisation criteria are of primary importance. However, as the AIFMD marketing passport is available only in relation to MiFID professional investors, it would also be desirable to have a workable opt-up regime for MiFID business.

For the reasons explained above, we believe it would be appropriate for the FCA to maintain the current position in relation to non-MiFID business, such that LAPFs (if not local authorities more broadly) can be treated as *per se* professional clients.

BVCA

The additional quantitative criteria under MiFID pose particular issues for PE/VC firms as we consider it very unlikely that any LAPF carries out 10 or more transactions per quarter in PE/VC funds. This reflects the fact that sophisticated investors tend to make a small number of large investments in PE/VC funds, as compared to their investments in listed securities (where they often undertake more frequent but smaller transactions). This means that the MiFID test contains an inherent disadvantage for managers of PE/VC funds because it is not designed to reflect the nature of investment in those vehicles. The MiFID test was designed for MiFID firms and was not revisited as part of AIFMD. This results in an inherent disadvantage for PE/VC managers when seeking to categorise LAPFs as elective professional clients under the MiFID test when compared to managers of bonds or listed equities. Both for this reason and to avoid gold-plating we accordingly propose that the MiFID changes should not be extended to non-MiFID business.

MiFID Business

If it is not possible to categorise LAPFs as *per se* professional clients as proposed above, we would prefer Option A (retention of existing criteria). Guidance on the application of the qualitative test would be helpful to BVCA members, especially if this confirms that LAPFs can typically be considered to be sophisticated investors. In addition, the guidance should also confirm the requirement that "the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged" (i.e. the third limb of the quantitative test, and not only the assessment of expertise and knowledge) should be applied, in the case of an investor that is a non-natural person, to those individuals carrying out the transaction on behalf of that investor.

If the FCA considers it necessary for policy reasons to strengthen the quantitative criteria, we do not see any material downside in increasing the portfolio size requirement for local authorities to €20 million (provided this size requirement is applied to the administering authority as a whole and not to individual pools of capital managed by that authority), as LAPFs investing in PE/VC funds typically manage portfolios substantially in excess of this amount.

As noted above, we do not anticipate that any LAPF investors will satisfy the transaction frequency requirements, so adopting Option B(i) would effectively preclude LAPFs from investing into PE/VC funds; we do not believe this would be a proportionate outcome.

Chapter 7. Applying MiFID II's remuneration requirements for sales staff and advisers to non-MiFID firms

Q17: Do you think we should explore applying MiFID II's remuneration standards for sales staff and advisers across to non-MiFID II business?

We do not think the FCA should explore cross-applying MiFID II's remuneration standards for sales staff and advisers to non-MiFID II business. In particular, we do not believe the MiFID II remuneration requirements should be applied to PE/VC firms that are sub-threshold AIFMs. In our view, such a move would unquestionably constitute gold-plating.

The regulatory requirements applicable to sub-threshold AIFMs were recently reviewed by HMT in connection with the implementation of AIFMD in its January 2013 consultation paper, '*Transposition of the Alternative Investment Fund Managers Directive*'. In its May 2013 response to that consultation paper,

HMT stated that, in the case of sub-threshold AIFMs of unregulated collective investment schemes, *"[t]here was no support for increasing regulatory requirements*" and *"[n]o case has been advanced for the Government to impose further regulatory requirements in this area as part of AIFMD implementation*".

We do not believe that any policy reason has arisen since May 2013 that would justify revisiting that position. We therefore do not see there is any case to be made for applying the MiFID II remuneration requirements to sub-threshold AIFMs or residual CIS operators. Such application would impose a cost and administrative burden on smaller firms where no investor protection or other issues have been identified.

Chapter 8. Recording of telephone conversations and electronic communications

8b. The current recording rules for discretionary investment managers

Q20: Do you agree that the two recording exemptions for discretionary investment managers should be removed?

Q21: Do you agree that discretionary investment managers should be required to comply with Article 16(7) of MiFID II?

We do not agree that the two recording exemptions for discretionary investment managers should be removed for PE/VC firms.

The BVCA engaged with the FSA when the domestic telephone taping regime was introduced in 2009, and the FSA confirmed in correspondence (copy attached) the circumstances in which PE/VC firms could rely on these exemptions. The exemptions have been widely relied on, and are particularly important for those firms for whom few conversations would be subject to a recording obligation, given the costs of implementing a recording system and managing the operation of such a system on an ongoing basis. The exemptions also help to avoid unnecessary duplication of costs, which would arise if the telephone taping obligation applied to both "buy-side" and "sell-side" firms.

Given the nature of PE/VC business, we do not believe that requiring PE/VC firms to record telephone conversations would materially assist the FCA to monitor compliance with conduct of business obligations or provide evidence to resolve disputes between firms and their clients. Market abuse concerns would, as now, continue to be addressed by 'sell-side' recording obligations.

We therefore consider that the incremental supervisory benefit (if any) of requiring such recording would be significantly outweighed by the financial and administrative costs to firms, especially smaller firms, of implementing such systems. Whilst we believe that the costs associated with such recording would be significant we have not, in the time available, been able to collate comprehensive cost data. We would, however, be happy to do so if this would be helpful.

Financial Services Authority

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Tim Lewis
Partner
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27 January 2009

Our Ref:

Your Ref:

Dear Tim

FSA rules on recording voice conversations and electronic communications

Thank you for your email to my colleague Matthew Fann of 11 December 2008. In the email you raised a number of issues on behalf of the BVCA in relation to our new rules on recording voice conversations and electronic communications (the "taping" rules), which were set out in PS08/1 and are due to come into force on 6 March 2009.

Subsequent to your email, my colleagues discussed these issues with yourself and others during a telephone conversation on 12 December 2008. The purpose of this letter is to confirm the details of that discussion, which we hope will provide useful assistance to private equity and venture capital firms when implementing the taping rules. We are happy for you to share the contents of this letter with BVCA members, via publication on the BVCA website or other means.

1) Scope of the rules:

   a) Investment activity.

      The taping rules only apply to certain conversations or electronic communications ("communications") that concern transactions in investments which are admitted to trading (or in respect of which a request for trading has been made) on EEA regulated markets ("prescribed markets") and other investments whose value depends on these investments (e.g. a conversation about a transaction in an OTC derivative of a share traded on the London Stock Exchange would be need to be recorded).

      Therefore, we expect the majority of transactions undertaken by private equity or venture capital firms, whose core business is growing the value of privately held companies, to be outside the scope of the rules.

We recognise, however, that some of the activities of private equity and venture capital firms may involve communications which relate to transactions in investments of a type that fall within the scope of the taping rules, for example as part of a "public to private" transaction, an exit by way of flotation, the sale of a residual holding in a company after a flotation, or more rarely the acquisition of a strategic minority stake in a listed company. In these cases, many of your firms will be able to rely on one of the exemptions in the rules (see (2) below). If firms cannot rely on these exemptions when they enter into transactions which are covered by the rules, they will need to take reasonable steps to record communications which fall within the definition of (b) below.

b) Communications that conclude an agreement or are carried on with a view to the conclusion of an agreement.

Firms are required to take reasonable steps to record communications which "conclude an agreement" (COBS 11.8.8R(1)). We would normally expect this rule to apply to private equity or venture capital firms when they place orders with a broker, as the firm will be concluding an agreement on behalf of a client.

Firms are also required to take reasonable steps to record communications which are "carried on with a view to the conclusion of an agreement" (COBS 11.8.8R(2)). Guidance in COBS 11.8.9G states that these communications include those that are intended to lead to the conclusion of an agreement, whether or not the agreement is eventually concluded.

We recognise that, in the private equity and venture capital business, communications relating to a potential transaction may take place over a long period of time and these communications are likely to involve a number of parties such as investors, professional advisors and target company management, both face-to-face and through various communication media.

The taping rules are not designed to capture most of these communications that take place over an extended period of time - whether they involve discussions about due diligence, negotiations or internal decision making, which by their nature could not result in transactions being completed. In addition, it should be clear from the rules that face-to-face communications do not need to be recorded, and neither do internal communications or communications with third parties other than clients or brokers (i.e. communications solely with target company management or providers of finance for a deal are not required to be recorded, unless these parties are clients of the firm).

As explained in PS08/1, the phrase "carried on with a view to" was designed to prevent technical evasion of the obligation to record communications that conclude an agreement, i.e. to prevent firms from only recording for a very limited period of time at the specific point of conclusion of a deal, and to ensure that conversations that are expected to lead directly to the conclusion of a transaction were recorded even if the deal did not ultimately go ahead.

The wording "carried on with a view to" is therefore designed to capture conversations relating to a transaction that are expected to lead directly to the conclusion of a transaction. Firms are best placed to judge when such communications take place. However by way of illustration, telephone conversations with brokers about the potential demand and pricing of a sale of a stake in a listed company, the bidding strategy for an acquisition in the market, or gathering expressions of interest from potential sellers, would not ordinarily be within the scope of the rules. Conversely, an instruction to a broker in the final stages of obtaining irrevocable undertakings from investors to buy a stake may be caught by the rules. We would expect an instruction to a broker to build a stake in a listed company to be within scope (unless the firm can use any of the exemptions mentioned below).

2) Exemptions:

a) Discretionary investment managers.

i) Communications between a discretionary investment manager and a party that is not subject to the taping rules that are infrequent, and represent a small proportion of the investment manager's total communications that are covered by the rules, are exempt from the taping requirements (COBS 11.8.6R(3)). Private equity and venture capital firms, whose communications with such parties could be infrequent but still represent a large proportion of their relevant communications, can also make use of this exemption provided that the total number of their relevant communications is small.

ii) A discretionary investment manager does not need to record communications with another firm as long as the investment manager reasonably believes that the other firm is subject to the taping rules (COBS 11.8.6R(2)). As a result, unless the exemption in (i) above applies, a private equity or venture capital firms will have to record relevant communications with overseas firms.

iii) The taping rules apply to firms which arrange for client orders to be executed (COBS 11.8.1R(1)). Therefore, a firm that arranges for orders to be executed on behalf of another firm that is acting as a discretionary investment manager is not covered by the discretionary investment manager exemption.

b) Corporate finance business.

i) Corporate finance business (as defined in the FSA Handbook Glossary) is exempt from the taping rules (COBS 11.8.2R(1)). As a result, if a private equity or venture capital firm is conducting corporate finance business within the scope of the definition, for example activities the firm may conduct with or for a fund or underlying company which relate to an exit by way of flotation, communications relating to these activities do not need to be recorded.

Yours sincerely

Stephen Hanks

Stephen Hanks
Prudential Standards, Conduct and Organisational Policy