Technical Briefing

November 2017

Subject	MiFID II – Some Key Issues for Private Equity and Venture Capital
Effective date	03 January 2018
Impact	MiFID II will affect all FCA-regulated private equity and venture capital firms to some extent, including those licensed by the FCA as AIFMs. Firms should seek professional advice.

This technical briefing is for information purposes only and its contents do not constitute advice. *The BVCA would like to thank all the Regulatory Committee members who helped us produce this document, in particular Tim Lewis (Travers Smith), Stephanie Biggs (Travers Smith) and Tom Taylor (BVCA).*

Background and summary

The FCA's second MiFID II Policy Statement sets out the last major pieces of the UK's MiFID II framework, which comes into force on 3 January 2018. This briefing highlights some key areas where BVCA engagement with the FCA has resulted in major improvements for private equity and venture capital firms between the original consultation drafts and the final version of the rules. This briefing is not a comprehensive guide to MiFID II and it does not cover areas where the FCA had little or no flexibility to accommodate industry requests.

The BVCA has engaged extensively with the FCA to help distinguish private equity and venture capital firms from other types of investment firm. Our aim has been to ensure as far as possible that the new MiFID II rules, designed principally for a world in which brokers and traders use organised platforms to deal frequently in freely transferable securities, are not inadvertently or inappropriately applied in a way that hinders private, long term, growth capital.

We are encouraged by the FCA's willingness to listen to the BVCA's representations, which makes the final position for private equity and venture capital in certain key areas better than we had feared. However, BVCA fund manager members should still be considering the new framework in some detail. Some, such as CAD-exempt adviser/arrangers, will be conducting MiFID business directly ("MiFID firms"). Others will be caught by the FCA's decision to extend (or 'gold plate') some of the new rules to firms that are not directly regulated under MiFID ("non-MiFID firms"), including AIFMs. Firms will need to understand the implications of MiFID II for their businesses and comply with the new rules accordingly.

This briefing covers BVCA engagement with the FCA on the following key aspects of MiFID II:

a) Record-keeping (or 'telephone taping') rules.
b) Client categorisation (for local government pension scheme administrators).
c) Best execution requirements.
d) Research and inducements rules.

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We have summarised the broad position for typical AIFMs and MiFID firms operating in standard private equity and venture capital structures here, with further detail below. This is not a substitute for professional advice.

How the MiFID II regime regarding:	…typically applies to:	
	AIFMs:	**CAD-exempt adviser/arrangers:**
Telephone taping	The rules will not apply to the extent that the firm's activities relate to *unlisted securities*. The rules will apply to activities relating to *listed securities*.	The rules will apply to the firm's arranging activities. The analysis will vary depending on the type of instrument and type of interaction involved and members should seek professional advice.
Client categorisation	LGPS investors will be retail clients unless firms use the new opt-up procedure to re-categorise them as professional clients.	LGPS investors will be retail clients unless firms use the new opt-up procedure to re-categorise them as professional clients.
Research and inducements	For most PE/VC funds, the FCA's gold-plated AIFM 'inducements ban' will not apply. These AIFMs may receive benefits (including research) from third parties if they are satisfied this enhances the quality of the firm's fund management services and there are no other conflicts.	These firms may receive benefits (including research) from third parties if receipt of the benefit enhances the quality of the firm's service to its advisory clients (i.e. the fund GP/manco) and there are no other conflicts. The 'quality enhancement' test has been made more stringent under MiFID II.
Best execution	For now, the enhanced MiFID II rules (including, in particular, data publication obligations) will not apply. The FCA will monitor outcomes in relation to full-scope AIFMs and may extend the rules in future.	The rules may apply to the firm's arranging activities. The analysis will vary depending on the type of instrument and type of interaction involved and members should seek professional advice. The data publication rules should not apply to the extent that the firm's arranging activities consist only of bringing together investors.

1. What is covered by the MiFID II rules on recording telephone and electronic communications (the 'telephone taping' rules)?

What does MiFID II prescribe?

MiFID II's record keeping rules require MiFID firms to record telephone conversations and other communications that relate to transactions concluded when a firm is 'dealing on own account' or is providing 'client order services' related to the 'reception, transmission and execution of client orders'. The aim of these rules is to assist national regulators in monitoring firms' compliance with market abuse and related conduct standards (such as those relating to 'best execution' - see below).

How is the FCA implementing this in the UK?

The FCA's new rules replace the existing taping regime for UK firms, which the FCA considers is already similar to the MiFID II regime in outcomes (if less so in the detail). The FCA has 'gold plated' the new regime, extending it to cover both MiFID firms and AIFMs when carrying on the activities of arranging (bringing about), dealing as agent or principal, managing investments or undertaking portfolio management for AIFs/CISs.

The BVCA's discussions with the FCA focussed on two important further considerations:

1. *Application to activities relating to unlisted securities*

   The BVCA successfully argued for an exclusion that means the new taping rules will now not apply to AIFMs to the extent that their activities relate to *unlisted* securities. In an unexpected, but helpful, development, the FCA has very recently extended this exclusion to MiFID portfolio managers as well. This is an important exemption, targeted at private equity and venture capital as a result of BVCA lobbying. Member firms will still need systems and processes in place to record relevant calls relating to listed securities (e.g. post-IPO sell-down), if applicable.

2. *Proportionality*

   The FCA has no discretion to limit the application of the rules for CAD-exempt adviser-arranger firms in relation to their arranging (bringing about) activities, so these firms are subject to the rules for activities relating to all types of securities, including unlisted securities. However, the FCA has used the Policy Statement narrative to re-state its commitment to regulating in a proportionate, conduct-risk-based manner in this area, and attempts to describe the scope of the rules accordingly. Firms are only expected to record communications that are intended to result in the conclusion of a transaction; the focus is on the end of the process leading to a transaction where the transaction is agreed or there is a reasonable prospect of the transaction being agreed. Conversely, conversations where the firm is 'merely feeling its way and reserving its decision' will fall outside the regime.

What does this mean for BVCA members?

Many private equity firms are not currently subject to any taping requirements. The BVCA's aim in our discussions with the FCA was to minimise any deviation from this position.

With this in mind, the BVCA pointed the FCA towards the extensive volume of communication involved in the extended negotiations leading up to the moment a private equity or venture capital fund makes an investment. Applying the taping rules to all these communications would create a hefty new burden for our industry, with little regulatory benefit. Private equity and venture capital deals are already accompanied by extensive paperwork that records much of any negotiations as well as any advice and agreed terms (and the manner of their execution). Market abuse risk is also completely absent in an 'off-market' context, and in any case, the 'consumer' of the relevant financial services is usually the fund, an affiliated manager, or a segregated institutional investor (all of which would be unlikely victims of mis-selling).

The inclusion in the final rules of an exclusion for discretionary portfolio management activity related to unlisted securities goes a long way towards achieving this. The exclusion should cover the principal activities of private equity and venture capital fund managers regulated under AIFMD. These will not fall into nor therefore suffer the full cost implications of the new taping regime (which could be extensive, particularly where cross-border firms are concerned, and once software updates, systems development and data protection rules are taken into account).

However, MiFID CAD-exempt adviser/arranger firms' 'arranging' activities will, in some circumstances, be subject to the taping requirements. In this context, the FCA's comments and commitment to proportionality are helpful, if not a complete answer. In some cases, it may also be possible to satisfy the record-keeping requirements through written minutes of face-to-face meetings or saved email communications rather than recorded telephone conversations. Firms will need to discuss their proposed approach with their advisers and come to a conclusion that takes into account their individual structures and processes.

2. How will local authorities be treated under MiFID II?

What does MiFID II prescribe?

MiFID II categorises local authorities as retail clients by default, although they may, if appropriate, 'opt-up' to 'elective professional client' status via a prescribed procedure led by the manager. This includes local authority pension schemes where these are not legally separate from the local authority itself. The revised categorisation also affects AIFM marketing activities, as the definition of 'professional investor' for AIFMD purposes piggybacks on the MiFID definition of 'professional client'.

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The standard MiFID opt-up procedure consists of a two-limbed test, with qualitative and quantitative criteria, which UK local authority pension fund administrators would find it exceedingly difficult to pass. However, MiFID II allows national regulators some flexibility to set alternative opt-up criteria for local authorities. The BVCA and others have engaged with the FCA to ensure that the UK opt-up criteria will enable the majority of local authority pension funds to continue to invest in private equity and venture capital funds as professional clients.

How is the FCA implementing this in the UK?

The FCA has no discretion over the qualitative limb of the test, which requires firms to assess and judge any local authority to which they provide services, on whether the authority is capable of making its own investment decisions and understanding the relevant risks. However, the FCA has helpfully clarified that where a local authority has a pensions committee, firms may take a collective view of the expertise, experience and knowledge of the committee members, taking into account any assistance from other local authority officers or external advisers.

In contrast to its lack of discretion as regards the qualitative limb of the test, the regulator does have the power to set 'alternative or additional criteria' for the quantitative limb. After extensive and co-ordinated lobbying by the BVCA, the Local Government Association and the Investment Association, the FCA has chosen to amend the standard MiFID II test in this context. A local authority will now meet the quantitative criteria if it has a financial instrument portfolio in excess of £10m and ticks at least one of the following boxes (box (iii) being expressly intended to address our concern that it would otherwise be exceedingly difficult to opt up LGPS administrators):

1) The authority has carried out at least 10 similar transactions per quarter, on average.

2) The individual carrying out the transactions at the local authority has held a role with similar responsibilities in the financial sector for at least one year.

3) The authority is acting in its position as an 'administration authority' of the Local Government Pension Scheme (defined in the LGPS Regulations 2013).

What does this mean for BVCA members?

The aim of the MiFID II rules is to protect local authorities from being mis-sold complex products that could endanger their treasury portfolios. The EU-level rules failed to reflect the fact that UK local authorities often also oversee the management of pension fund assets, and are sizeable investors in illiquid alternative asset classes like private equity and venture capital. The BVCA therefore worked with the Investment Association, the Local Government Association and other asset managers to encourage the FCA to use its discretion to make the opt-up tests work for UK local authority pension funds.

The resulting extra limb to the quantitative test means that UK local authorities will retain a route into private equity and venture capital; albeit one that requires a little more paperwork. The LGA (working again with the Investment Association, the BVCA and others) has developed templates for this paperwork. These are available here, along with a useful process flow and timetable. Local authorities wishing to be opted up can complete and send a copy of the templates to their managers, who will then be able to carry out the opt-up procedure where appropriate. We are aware that many BVCA members have followed the FCA suggestion that firms begin the procedure now, in advance of 3 January 2018.

Is it necessary to opt up local authorities that are already investors in BVCA members' funds?

Fund managers should not usually need to opt up local authorities that are already investors in existing funds, particularly where these are typical, private-equity-style closed-ended AIFs. However, the answer will vary according to the precise structure and nature of the services provided by each manager. In particular, the analysis may be different for managers running or planning new segregated mandates, top ups or roll-overs. BVCA members should consider all their existing relationships with local authority relationships and seek specialist advice in each case.

3. What is covered by the MiFID II rules on inducements and research?

What does MiFID II prescribe?

MiFID II imposes an 'inducements ban' on portfolio managers and independent investment advisers, prohibiting them from receiving fees or non-monetary benefits from third parties in connection with their investment activities for clients. Other firms, including non-independent advisers (which would include private equity and venture capital adviser/arrangers), may continue to receive third party benefits if they are satisfied that the arrangement is designed to enhance the quality of the service received by the firm's advisory client (i.e. the fund GP/manco) and there are no other conflicts. The 'quality enhancement' test is more stringent under MiFID II, requiring firms to identify a tangible benefit to the advisory client that is proportionate to the benefit received by the firm from a third party.

In relation specifically to research, MiFID II requires MiFID sell-side firms to price and account to their clients for execution and research services as separate items, and imposes detailed requirements on how this should be done. As a result of the inducements ban, buy-side firms undertaking portfolio management may no longer receive research on a 'free' or bundled basis, but must pay for research from the firm's own resources or levy a separate, ring-fenced research charge on clients (known as the 'research payment account' or 'RPA' model). Non-discretionary, non-independent advisers may, in principle, continue to receive 'free' research if the (more stringent) quality enhancement test is satisfied and there are no other conflicts.

How is the FCA implementing this in the UK?

The FCA is extending the MiFID II inducements ban, and the related research payment rules, to AIFMs when executing client orders or placing orders for execution. As a result of BVCA engagement, the FCA has included a carve-out for funds that do not generally invest in custody assets and/or generally invest in companies to acquire control (the AIFMD 'proxy' definition of a private equity fund; these funds will typically be using a PE depositary).

What does this mean for BVCA members?

These rules are clearly not designed with private equity or venture capital in mind. They are intended to end amongst other things the practice of ‘bundling’, where a broker or investment bank provides an asset manager with research on various financial instruments that is paid for via client dealing commissions, which can act as an inducement for the asset manager to carry out trades with that broker or bank.

However, the rules are broadly drafted, and we were concerned that BVCA members’ due diligence on potential acquisitions of unlisted companies might be considered a form of research benefit. The FCA considered that this would most likely be the case, but accepted the BVCA’s representations that (in the FCA’s words):

“The conduct risk of a firm over-paying for research … or having their trading behaviour influenced … appears reduced in the private equity model, where transactions are generally infrequent and often carried out on a negotiated basis. Inducement risks are also mitigated by existing conventions of directly invoicing the fund for specific research / due diligence services, and requirements in AIFMD for managers to agree ex ante with investors the scope of charges that can be deducted from the fund.”

Private equity AIFMs and adviser/arrangers will therefore typically be able to apply the 'quality enhancement' test to their receipt of research, including due diligence reports. Firms will need to assess whether they are, on the facts, comfortable that the test is satisfied.

There is a continuing issue for MiFID portfolio managers subject to the inducements ban, who are not able to apply the 'quality enhancement' test. These firms should seek professional advice.

4. How will the MiFID II best execution regime apply to private equity & venture capital?

What does MiFID II prescribe?

Under MiFID II, MiFID firms will be held to higher best execution standards and must comply with specific new disclosure obligations concerning the publication of order and execution venue data.

How is the FCA implementing this in the UK?

The FCA originally contemplated applying these requirements to AIFMs in addition to MiFID firms. Following industry representations, the FCA has decided that it will not extend the MiFID best execution rules to UK full scope AIFMs for the moment, pending the European Commission's review of AIFMD (which is unlikely to be complete before 2019) and further monitoring of the sector. (The AIFMD best execution rules do, of course, continue to apply.) Nor will the rules be extended to sub-threshold AIFMs, apparently more permanently.

What does this mean for BVCA members?

'Best execution' (the obligation to execute clients' transaction orders in the clients' best interests e.g. as quickly and reliably as possible and at the best price available) is a relatively alien concept to private equity and venture capital, because it is largely irrelevant to the industry (except where a manager acquires listed securities or debt instruments). In discussion with the FCA, the BVCA drew the regulator's attention to the fact that no meaningful 'order', 'execution venue' or 'execution data' exist for private equity and venture capital transactions in unlisted securities. This position is supported by Recitals 45 and 46 of the AIFMD 'level 2' regulation, which dis-apply best execution requirements for AIFMs carrying out negotiated transactions in non-listed companies, essentially on the grounds of irrelevance, because 'no order is executed'.

The fact that the regime has not been extended to AIFMs is therefore welcome. Private equity CAD-exempt adviser/arranger MiFID firms are, again, not specifically excluded. However, these firms should fall outside the regime in practice, due, again, to the lack of order or execution venue and the fact that in practice they generally only undertake the reception and transmission of client orders in the sense of bringing together two or more investors (usually the fund and the seller/buyer who then enter into the transaction documents directly). However, firms should seek professional advice on their own structures and practices.

Conclusion

The MiFID II rules are not generally designed nor appropriate for the supervision of private equity and venture capital firms. The BVCA has been in regular contact with the FCA throughout the UK implementation process, and the resulting raft of sensible exclusions is a welcome sign of the UK regulator's capacity for pragmatism. To the extent the FCA has flexibility, it has largely been willing to accept that rules clearly targeting behaviours in other parts of the financial services industry should not apply to most private equity and venture capital managers' activities. This has mainly benefited private equity AIFMs, where BVCA engagement has resulted in significantly reduced gold-plating. Some of the more pragmatic FCA commentary is also helpful to exempt-CAD adviser/arranger firms when applying the new rules. However, for these firms there are many areas where the FCA does not have flexibility to amend the MiFID II framework; these are not covered in this note. All member firms, particularly those who are MiFID firms, should seek professional advice on MiFID II implementation if they have not already done so.

If you have any questions on the topics raised in this note, please contact Tom Taylor (ttaylor@bvca.co.uk).

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