Robin Mueller, Chris Thresh, Jake Matthews
Corporate Governance, Audit Reform and Shareholder Rights
Department of Business and Trade

Email: robin.mueller@beis.gov.uk

14 April 2023

Dear Sirs

Re: BVCA comments on Audit and Corporate Governance Reforms – Extending the definition of a Public Interest Entity

We are writing on behalf of the British Private Equity and Venture Capital Association, which is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 700 firms, we represent the vast majority of all UK-based private equity and venture capital firms, as well as their professional advisers and investors. Between 2017 and 2021, BVCA members invested over £57bn into around 3,900 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private equity and venture capital ("PE/VC") currently employ two million people in the UK, and 90% of the businesses our members invest in are small and medium-sized businesses.

Introductory comments

As we have set out in previous discussions and consultation submissions, an important part of the PE/VC business model is to build robust and effective governance structures, fostering growth and innovation and creating long-term value, as demonstrated by many academic studies. The PE/VC industry is committed to additional governance and transparency, and examples of this in practice include the BVCA's work on the Wates Principles for Large Private Companies and the Walker Guidelines, implemented and monitored by the Private Equity Reporting Group ("PERG").

The BVCA continues to support, and be involved in, government initiatives on corporate governance reform. Through our work on the Wates Principles for corporate governance and the Walker Guidelines on transparency, large UK private equity-backed companies currently provide significant levels of disclosure. Indeed, in many of these areas, private equity-backed companies are leaders, with a sharp focus on effective governance and responsible stewardship. Companies covered by the Walker Guidelines already comply with some of the requirements currently applicable to Public Interest Entities ("PIEs"). Furthermore, the PERG has embarked on refreshing the Walker Guidelines to ensure that the industry continues to provide not only significant but also quality transparency and disclosure.

The private equity and venture capital approach

PE/VC firms are long-term investors, typically investing in companies for around three to seven years. This means a commitment to building lasting and sustainable value in the businesses they invest in. Typically, firms will sell their stake in a company by listing it on the public markets or, more frequently, selling to a strategic buyer. PE/VC firms raise capital to invest from sources such as pension funds, endowments, insurance companies, banks, family offices/high-net-worth individuals and sovereign wealth funds. PE/VC funds will invest in companies ("portfolio companies") in the earlier part of a fund's life until an agreed date (e.g. five to six years) and exit those investments in the run up to the fund's tenth anniversary (which can be extended). The fund's ownership percentage in the portfolio companies will vary depending on the PE/VC strategy (e.g. buyout, minority stake). Private equity acquisitions will often be partly financed by debt, often provided by a number of banks or other debt providers. Importantly, the portfolio companies will operate independently of each other and not as a single corporate group.

BVCA feedback

We welcome the opportunity to comment on the expansion of the definition of a PIE to include private companies.

We have set out some considerations below. We would like to note that many of the points set out have been taken from previous BVCA responses.

Scope of new PIE definition

We understand the rationale for including some of the largest private companies within the definition of a PIE and agree with raising the thresholds from what was originally proposed in the 2021 consultation.

However, we note that – unlike in a public company – additional mandatory reporting is not required by shareholders in a private company, who are in a position to seek and obtain the information that they need in a format and with the frequency that is decision-useful for them. In many cases extensive reporting and corporate governance arrangements for larger private companies are already in place, and it would be more beneficial and applicable for private businesses to be governed by these requirements instead, such as the Wates Principles.

The Wates Principles are relatively new, and more time is needed to judge their effectiveness before imposing new requirements. As the PIE requirements are designed to better apply to listed companies (who have more resources and experience of extensive reporting), a more flexible and tailored set of requirements for private businesses would be more suitable, similar to the approach taken under the Wates Principles.

Alongside the phased approach for implementation, including the temporary exclusions (from some of the new requirements) for newly listed companies, it would be appropriate to exempt private companies more generally from some of the requirements applying to listed companies, or provide for an alternative approach which is more tailored and less burdensome (e.g. on the internal controls attestation). A much longer phased approach would be needed for high growth companies that are growing very rapidly, as this would give them more time to adjust.

Additionally, with the new reporting regulations proposed in March 2023 (to come into force in January 2025), it would again be more beneficial to let these embed into financial reporting for large private companies before expanding the definition of a PIE.

Timeframe for implementation

The BVCA is supportive of the timeframe presented in the explanatory note.

Additional audit requirements - provision of non-audit services

If the PIE definition is expanded, it is important to ensure that the regulation/legislation reflects the specificities of a typical PE/VC fund and does not treat it in the same way as a conglomerate/large corporate group.

The provision of non-audit services (that are restricted under current regulation) should still be permissible to other companies (that are not PIEs) in the same PE/VC fund that contains one or more PIEs, and non-audit services to the PE/VC funds should still be permissible if they do not relate to the PIE(s). We agreed a sensible approach with the FRC on this matter when it expanded its ethical standard in 2019 to include large private companies. That approach sits within guidance and should be rolled into new regulation/legislation that applies to PIEs. If that approach was not maintained, given the amount of non-audit services provided to PE/VC portfolio companies by both 'Big 4' and challenger firms there is also concern that there would not be an appetite in the market to take on audits of PIEs held by PE/VC funds.

In 2019 and early 2020, the BVCA engaged with the FRC on its revised Ethical Standard[1] which limits the provision of non-audit services by audit firms to their audit clients that are classified as PIEs or Other Entities of Public Interest ("OEPIs"). The standard became effective for PIEs for accounting periods commencing on or after 15 March 2020, and for OEPIs for periods commencing on or after 15 December 2020. We have set out below comments on *how* the restrictions will apply rather than the restrictions themselves[2].

The BVCA has always supported measures to improve quality and independence in the audit market. The reason we sought an adaptation to the FRC's initial proposals was to accommodate the fund structures used in our industry so as to not to limit choice for PE/VC firms.

The structure of private equity funds, and the way in which firms invest in and manage businesses, is very different to a typical corporate group. However, the Ethical Standard still applies because private equity funds will typically have controlling stakes in the portfolio companies in which they invest. Portfolio companies are acquired and sold by the fund more frequently than in a corporate group which adds to the complexity of managing independence conflicts as many audit firms will be used. In turn this means that there can be unintended consequences such as delays to a transaction timetable to address independence requirements, even where the threats to auditor independence are limited or non-existent. Private equity firms can therefore be at a disadvantage to corporate groups in a M&A process as it is more difficult for them to impose a change of audit firm or prevent a portfolio company from using an audit firm.

[1] FRC Revised Ethical Standard December 2019 – available here

[2] In broad terms, the restrictions limit advisory, including tax, services that can be provided by auditors of companies that are classified as PIEs and OEPIs to reduce conflicts of interest and other threats that could impair auditor independence.

When the government expands the definition of a PIE, we need to ensure the outcome agreed below (to address our concerns on choice of auditors) is carried forward into new regulation/legislation.

Structure of a PE/VC fund and its portfolio companies

PE/VC firms typically use a limited partnership to structure funds and an example of a structure is set out below.

- The general partner of the limited partnership fund will delegate its power and authority to the private equity manager (often limited liability partnerships with the partners being the PE/VC executives).
- PE/VC firms will manage one or more funds. The funds are closed-ended meaning that they have a limited life span, the industry standard being 10 years. The life span of a fund can be extended (if permitted in the fund's constitutional agreement) and this is typically up to two additional years.
- PE/VC firms raise capital to invest from sources such as pension funds, endowments, insurance companies, banks, family offices/high net worth individuals and sovereign wealth funds. These overwhelmingly institutional and well-informed investors will be limited partners in the fund and their liability is limited to the capital provided to the fund.
- The funds will invest in portfolio companies in the earlier part of a fund's life until an agreed date (e.g. 5 to 6 years) and exit investments in the run up to the fund's tenth anniversary. Typically, firms will sell their stake in a company by listing on the public markets or, more frequently, selling to a strategic buyer.
- The fund's ownership percentage in the portfolio companies will vary depending on the PE/VC strategy (e.g. buyout, minority stake).
- Private equity acquisitions will often be partly financed by debt, often provided by a number of banks.
- The portfolio companies will operate independently of each other.

In contrast to a corporate group which, more often than not, will use one firm for the audit of all its group companies, PE/VC structures (i.e. the manager, fund(s) and its portfolio companies) do not operate in the same way. In particular, many PE/VC firms do not see it as their role to intervene in portfolio company management's decision as to which firm is engaged as auditors. Hence, it will often be the case that many different firms audit different portfolio companies.

The expansion of the PIE definition will bring into scope larger portfolio companies, who may have several different audit firms providing services. The portfolio companies and the PE/VC firm would then potentially be restricted in using any of these audit firms for services that it itself is looking to procure (even for the provision of services in relation to an unrelated portfolio company which itself is not a PIE). This restriction on choice is a significant issue as it conflicts with another fundamental point for a PE/VC firm, being their obligation (both contractually under the fund documentation and as a fiduciary acting in the best interests of its investors) to seek support and advice from the most relevant and appropriately experienced advisors. This advice includes due diligence services.

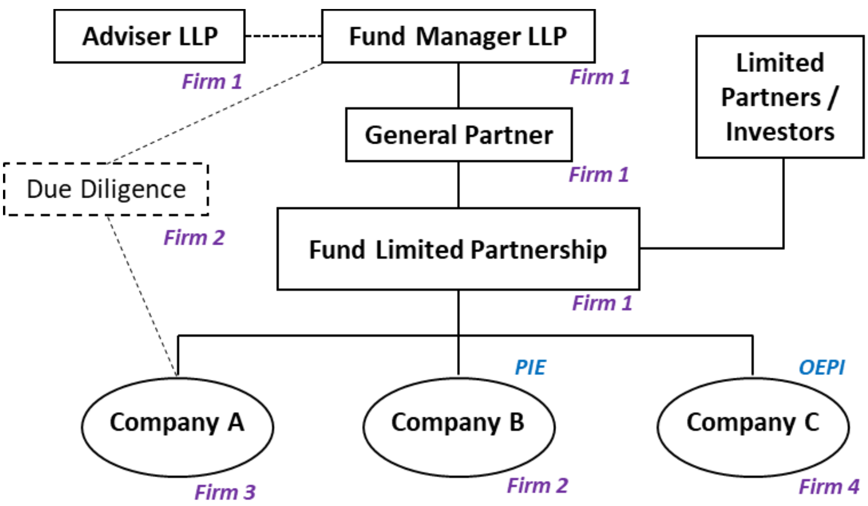
Practical impact of the Ethical Standard

In our engagement on this topic, we did not seek a general exemption for PE-backed portfolio companies (from the non-audit services restrictions) where they themselves are PIEs or OEPIs. However, we did want to ensure that these restrictions did not taint the other entities in a fund structure, including other (non-related) portfolio companies, and the fund manager.

In February 2020, the FRC published implementation guidance[3] which clarifies what the "fund management entities" are in a typical fund structure and this ensures the restrictions on non-audit services are ringfenced to the OEPI in question (amendments for PIEs could not be made as that was in legislation).

Some PE/VC firms already have some experience of the current and previous Ethical Standard where there are PIEs in their structures. The OEPI category[4] is a new UK definition and expands the types of companies covered by the Ethical Standard. The definition of an OEPI includes large UK private companies that meet the criteria to report on the corporate governance requirements (UK companies that are not already required to report on their corporate governance arrangements with either: 2,000 or more global employees; or turnover over £200m globally and a balance sheet over £2bn globally). Importantly, this definition excludes "fund management entities which are included within a private equity or venture capital limited partnership fund structure".

The requirements for OEPIs partly follow the non-audit services restrictions applicable for PIEs. The permitted list of non-audit services applies to OEPIs, but the 70% non-audit services fee cap does not. The FRC approach to exclude fund management entities means that the advisor, the fund manager, the general partner and the fund itself based on the diagram below cannot be an OEPI. The effect of the FRC implementation guidance is that whilst technically the fund is the parent of the OEPI, the fund and the other fund management entities *themselves* are exempted from becoming OEPIs.



[3] FRC implementation guidance, February 2020 – available here
[4] FRC Glossary of Terms (Auditing and Ethics), December 2019, see page 22 – available here

The BVCA has sought to help members understand the impact of the standard. This does not represent BVCA guidance for the private equity and venture capital industry as the application of the Ethical Standard to a particular fund structure will be fact-specific and early engagement with the relevant auditors is required. The above adaptation of the rules could also apply to other strategies/sectors that operate in a private equity-like manner.

The above adaptation of the rules cannot currently be applied to PIEs as that definition is in legislation. i.e. if the fund management entities already meet the definition of a PIE, they cannot be excluded. Therefore it is crucial that as part of the implementation of changes to the definition of a PIE, the approach taken for OEPIs is carried forward to cover PIEs in a private equity structure.

The BVCA would of course be willing to discuss this submission with you further - please contact Ciaran Harris (charris@bvca.co.uk) at the BVCA.

Yours faithfully,

Tom Taylor

Head of Policy, BVCA