BVCA response to Treasury Select Committee inquiry on the future economic relationship with the EU – transitional arrangements

1. The BVCA and our members' contribution to the UK economy

The British Private Equity and Venture Capital Association ("BVCA") 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 and investors.

Investment into UK businesses and employment

Private equity and venture capital firms are long-term investors, typically investing in unquoted companies for around three to seven years. This is a commitment to building lasting and sustainable value in business.

Our members have invested over £27 billion in nearly 3,900 UK-based companies over the last five years. Private equity and venture capital funds managed in the UK currently back around 2,980 companies, employing over 900,000 people on a full-time equivalent basis ("FTEs") across the world. Of these, around 385,000 FTEs are employed in the UK and 333,000 are employed in the rest of the EU. In 2015, 34 companies experiencing trading difficulties were rescued by BVCA member firms, helping safeguard around 16,500 jobs.

Of the businesses invested in during 2015 in the UK, 63% were small companies, with a further 21% being medium-sized companies. In 2015, London and the South East were the regions that attracted the most capital, with £2.5bn invested in London and £800m in the South East. Other regions that saw notable levels of investment include the North West at £425m and Yorkshire and the Humber, where £770m was invested.

A global leader that generates strong returns for investors

The UK is a global hub for venture capital and private equity and our investor base includes pension funds, insurance companies, sovereign wealth funds and corporate investors. Our members have demonstrated their consistent ability to outperform other asset classes. On a since-inception basis, UK funds returned 13.8% in 2015, and the 10-year IRR generated 13.2%, nearly double that of pension fund assets and the FTSE All-Share.[1]

Our interaction with the EU

The UK private equity and venture capital industry requires and encourages cross-border investment with the rest of the EU ("rEU"). Operations, systems and processes are also intrinsically cross border, and need to be for the industry to be cost effective and function efficiently.

Over the past three years, 18% (£6.1 billion) of funds raised by the UK industry were from rEU countries. With respect to investment activity, over the past three years 40% (£16.3 billion) of funds were invested in companies based in the rEU. A loss of access to the European market would substantially impact the ability of the UK industry to raise funds and could reduce the amount of investment available to businesses in both the UK and Europe.

[1] BVCA Performance Measurement Survey 2015 – available here

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2. The importance of transitional arrangements

2.1. Dealing with uncertainty

The central concern arising from our discussions and work with members has been that Brexit is leading to uncertainty and firms are now reviewing how they manage their existing businesses in light of this. This will entail analysis of whether or not to locate part of a firm's business in another EU Member State to ensure continued access. This type of contingency planning is an option that is typically only available to larger managers given the costs entailed in seeking professional advice and potential operational changes. The majority of the BVCA's members are in fact smaller firms that may not be able to incur the costs related to such contingency planning. Transitional arrangements are therefore of even more importance to smaller businesses.

2.2. Investor access

A key priority for our industry is to ensure UK firms still have access to EU investors and vice versa. Choice is essential for investors to ensure portfolio diversity and access to the best returns for their ultimate beneficiaries, which include pension funds, university endowments and insurance companies.

Private equity funds are generally structured as limited partnerships which classify as "Alternative Investment Funds" under the EU's Alternative Investment Fund Managers Directive ("AIFMD"). The ability of any private equity fund manager to market their fund to EU investors is determined by AIFMD together with local laws specified on an individual Member State basis. Following AIFMD, there are essentially three models for marketing:

1. **Full scope AIFM established in the EU with an EU fund**. On this model, an EU based fund manager becomes fully authorised under AIFMD and must comply with all the requirements of AIFMD. Funds must become authorised under AIFMD where their funds under management exceed a certain amount (Euro 500m for private equity). In the UK, such managers are authorised by the FCA. Where such a manager raises a fund which is established in the EEA, it may market that fund to professional investors throughout the EU using a marketing passport. The majority of EU AIFMs within this category are established in the UK[2].

2. **AIFM established outside the EU but (i) in an equivalent jurisdiction and (ii) regulated by an EU regulator**. On this model, a non-EU fund manager could have the same passporting rights as an EU manager. However this is only available where two conditions are satisfied. First, the non-EU manager and its fund are located in a jurisdiction deemed equivalent by the European Commission. No jurisdiction has yet been deemed equivalent, so this is not currently an option under AIFMD. Second, the manager must comply with all the requirements of AIFMD, have an office in the EU and be regulated by an EU regulator. Given the unattractiveness of this "equivalence" regime, it is unclear whether any firms would choose to use it rather than set up an EU office under 1 above.

[2] According to the EU register of authorised AIFMs maintained by ESMA, 430 EU AIFMs are located in the UK—just over one-fifth of all EU AIFMs and more than in any other European country. In addition to private equity, these figures include all kinds of Alternative Investment Fund, such as real estate and hedge funds. The marketing rules for these funds are the same as those for private equity funds established under AIFMD.

3. **Managers of non-EU funds and smaller EU funds: national private placement regimes**. These managers are only permitted to market into an EU Member State where the Member State permits this under its local law (so called National Private Placement Regimes ("NPPRs")). Non-EU funds must also meet some additional criteria under AIFMD.

Where a manager is regulated under 1 above, it is obliged to market its EU funds using the passport; it is not permitted to select option 3. As a result of the above structures, we have a number concerns about cliff edge effects which we consider could be resolved with transitionals.

Issues for UK full scope AIFMs: Many UK AIFMs fall within category 1 above. A sensible transitional arrangement between the UK and the rEU needs to be in place to avoid cliff edge scenarios on "Brexit day". For example, without a deal in place, a UK-based fund manager within category 1 that is partway through raising funds from EU investors using an AIFMD marketing passport, would cease to be an EU AIFM mid-fundraise and would have to cease its activities, leading to significant business disruption. This would have a negative impact on the fund manager, its prospective and existing investors and indirectly, business partners and other financial institutions. In this scenario, the UK firm would not have been able to use the NPPRs as it would have been required to be fully authorised under the AIFMD. Similar issues arise for firms that are using the AIFMD passport for managing funds in other parts of the EU on a cross-border basis.

Given that the fundraising cycle for a new fund can last from six months to two years, this is a real risk. The risk for UK managers is that either (i) they may be unable to make new investments in the real economy because they are no longer able to raise funds due to the cliff edge effects or (ii) they decide to move jobs to rEU to set up an office from which they can raise the fund in a way which avoids the cliff edge risk.

This issue also poses a significant risk for EU investors. Currently those investors rely on the passporting system to invest into UK managed funds. Following the introduction of AIFMD, the added costs of compliance meant that there was not a simple and cost effective way for non-EU managers to access EU investors. As a result, we understand anecdotally that many smaller managers (including many US managers) stopped making funds available to EU investors. There is a risk that this issue will be amplified post-Brexit for EU investors because of the significant investment made by such investors into UK managed funds. EU pension schemes and insurers rely on their investments in UK funds to generate investment returns. Limiting their investment universe would affect them adversely.

The future of NPPRs: A further risk is that UK firms start seeking to use NPPRs post-Brexit, but Member States then unilaterally restrict firms' ability to rely on these. Well-functioning European NPPRs are essential to maintaining global capital flows and must be preserved even if a third country passport under AIFMD becomes available. This is a point that has been made consistently by the BVCA in representations on the Capital Markets Union project, as well as consultations on the AIFMD third country passport. There is a growing appreciation of the complexities associated with obtaining access to the EU's single market through passporting and equivalence regimes. This includes the practical challenges of using the proposed AIFMD third country passport in its current form and the sustainability of any future equivalence determination. As there is no date for the completion of this work, this area remains uncertain for an industry that requires a level of clarity in order to set strategic plans and make long term investments. Therefore, as a minimum, European NPPRs must remain open to UK firms, even if third country access is granted to UK firms through a new relationship with the rEU.

2.3. Tax matters

In terms of tax, one of the key issues on leaving the EU is that the UK may no longer be able to benefit from various EU treaties, tax directives and regulations. As highlighted above, cross-border investment is an important feature of UK private equity funds. One issue firms are reviewing is whether there will, in the future, be withholding tax on cash flows of interest and dividends up to UK holding companies within portfolio groups. Ultimately this will impact investor returns in situations where investors suffer more tax on investments made through a fund than if they had invested directly.

All EU Member States are party to two European Directives which remove withholding tax on dividends, interest and royalties in most cases – the Directive on parent companies and subsidiaries in different Member States (commonly known as the EU Parent-Subsidiary Directive) and the Interest and Royalties Directive. If access to these Directives is lost following UK's exit from the EU, the use of UK holding companies for investments within the EU may be impaired due to potential for tax leakage on dividends and interest paid by an EU subsidiary to its UK parent. While it should still be possible for the relevant double tax treaty to apply, the UK's treaties are not always as beneficial as the EC Directives as they do not, in fact, always provide for nil withholding tax on dividends and interest. A transitional arrangement would need to address this issue.

2.4. Other areas

The BVCA is assessing the impact of Brexit on the portfolio companies in which our members' funds are invested and also the UK industries that rely upon a thriving private equity and venture capital sector, including banking, administration, legal and consulting. Given the wide range of sectors covered by these portfolio companies, our efforts are currently focussed on private equity and venture capital-specific issues at a transactional level that impact our member firms directly. In the interim, there needs to be continuity in access to financing products for these companies.

3. The timing of a transitional arrangement

For a transitional arrangement to be effective and encourage businesses to remain within the UK and continue to do business and base their operations here, an agreement must be reached sufficiently early on in the negotiation process. A transition period will not only benefit UK firms, but also provide certainty to EU investors and businesses. Furthermore, it will provide comfort to global investors as well by reducing the risk of disruptive changes to the UK's operating environment. At this stage, further outreach is needed to determine what the optimum period is for such an arrangement as it could differ depending on the area under review.

A transitional arrangement with grandfathering will give UK firms the requisite time to plan for and adapt to changes. At present, firms that need access to the EU are planning on the basis that no special rights of access are in place. This requires consideration as to whether to create a presence in an EU Member State and to assess their position. To complete this assessment, firms are having to commit resources and seek advice on operational changes they may need to make. A degree of certainty and continuity is important so that businesses can plan for these changes.

The UK has enjoyed high levels of investment due to the stability of our legal system and regulatory regime. Appropriate transitional arrangements are key to preserving that stability.