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By email: cp15-08@fca.org.uk

6 May 2015

Dear Matteo,

Re: BVCA response to the FCA's Quarterly Consultation No. 8 (CP 15/8)

The British Private Equity and Venture Capital Association ("BVCA") is the industry body for the private equity and venture capital industry in the UK. With a membership of over 500 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. This submission has been prepared by the BVCA's Regulatory Committee.

Our members have invested £30 billion in over 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 790,000 people and almost 90% of UK investments in 2013 were directed at small and medium-sized businesses.

We would be happy to discuss any of the comments made in this response in further detail and thank you for the time you have spent with us to date on the matters raised. If this would be helpful, please feel free to contact Gurpreet Manku at the BVCA in the first instance.

Yours sincerely

Sheenagh Egan
Chairman – BVCA Regulatory Committee

BVCA response to the FCA's Quarterly Consultation No. 8 (CP 15/8)

Valuation Q&A

Q4.1: Do you agree with our proposed questions and answers on the valuation obligations under AIFMD?

Summary and context

It is important to recognise that determining the valuation of investments in private equity and venture capital ("PE/VC") funds is an inherently complex area. This is due to the nature of investments made by PE/VC funds which are typically into unquoted companies which are illiquid and not freely marketable. Valuation accordingly requires detailed company-specific knowledge and the involvement of portfolio managers. Full scope UK AIFMs managing PE/VC funds are generally opting to perform the valuation function themselves given their experience of performing this role and the level of investment-specific knowledge required to do it effectively (i.e. knowledge about the unquoted company being valued and the industry and markets in which it operates).

We are concerned that the proposed Q&A set a higher threshold for UK AIFMs performing the valuation task to be considered to be functionally independent from portfolio management. Our concerns primarily relate to the answers to Q1.7 and Q1.10 and we have some suggestions to help clarify the answer to Q1.4.

The proposed requirements in the answers to Q1.7 and Q1.10 will, in our view, effectively require hierarchical independence given the seniority of the individuals needed to perform the valuation function and the involvement of portfolio managers in a decision making capacity (rather than being restricted to an advisory role). This is compounded by the fact that most PE/VC firms are relatively small owner-managed businesses. In most cases, valuation committees/functions are chaired by an individual not responsible for portfolio management (e.g. the CFO, COO) who reports into a CEO and the CEO will have oversight of the portfolio management function. Notwithstanding the fact that the AIFMD requirement is limited to achieving functional independence, to require hierarchical independence would be disproportionate and in practice would be almost impossible to achieve without significant costs, costs which many firms will not be in a position to cover e.g. hiring senior non-executives with the requisite experience or an external valuer.

Given the nature of investments being valued, participation of portfolio managers in the valuation function in a decision making role is a necessity and indeed is expected by investors (who are generally highly sophisticated). Coupled with the seniority and experience required to effectively evaluate and review valuations, it makes it inevitable that many of those individuals will be supervised by those responsible for the portfolio management function and those individuals (but not necessarily all) will be compensated based on the performance of that function. Instead of limiting *all* portfolio managers to an advisory role, we believe a more appropriate position would be to allow portfolio managers to determine final asset valuations but restrict portfolio managers from voting on the assets they are directly responsible for.

Determining how to achieve functional independence of the valuation task from portfolio management is intrinsically linked to the level of conflicts of interest that arise when performing valuations in-house. There are a number of factors which reduce the potential for conflicts of interest when carrying out PE/VC valuations and this is a fundamental point when assessing how to ensure impartially when performing this task. Valuations of investments (and the fund's NAV) are of limited relevance with respect to their impact on management fees and carried interest/other incentives paid to portfolio managers:

- The valuations of investments for the majority of PE/VC funds have no direct impact on the fees paid by investors. The PE/VC model works on the basis of a pre-agreed management fee based on the value of committed/called capital, not on unrealised fair values.
- Subsequent carried interest is only paid to the manager on realised cash-to-cash returns, not on unrealised investment valuations (although this may vary). The valuation is therefore typically provided to the investor for information and accounting purposes to allow investors to make interim assessments of performance.
- As funds are (generally) closed-ended, and fund interests transfer infrequently between experienced secondary market participants who perform their own independent assessments of value, valuations performed by the manager are not the principal driver of pricing for trading purposes.

Where valuations do not impact the fees paid by investors and carried interest allocated to managers, investors' interest in valuations will be limited to reporting purposes. The level of scrutiny by investors would undoubtedly increase where valuations were a basis for fees, given the sophisticated nature of investors in PE/VC funds.

Furthermore, the Q&A do not take into account other processes that are in place to mitigate potential conflicts of interest that could arise in respect of the valuation process. In their policies and procedures, AIFMs are required (under Article 67(4) of Level 2) to document the safeguards in place to prevent or restrain inappropriate influence. For example, ensuring portfolio managers act only in an advisory capacity when determining the valuation for the individual investment(s) *they* are responsible for. Where policies and procedures are in place to ensure impartially and independence in the process, and the potential for conflicts of interest is low, then the additional requirements proposed (in particular in the answer to Q1.7) are not needed.

We believe the proposals will cause undue costs and significant disruption to policies and procedures already implemented by firms to the satisfaction of their investors, auditors and the FCA (as part of the firms' AIFMD applications).

Question 1.4: Does the valuation function involve valuing the assets and liabilities of an AIF?

The valuation function involves valuing all investments held in the *AIF*'s portfolio. This is regardless of whether the investments constitute assets or liabilities.

Therefore, positions in derivatives or short positions, as well as other investments which have

a negative value or are held at a loss, are part of the portfolio of an *AIF* and should be valued as part of the valuation function.

The proper valuation of all the liabilities of an *AIF* is needed to calculate the net asset value of the *AIF*. This includes valuing liabilities which are not investments so are not required to be valued as part of the valuation function, such as management fees and accruals. The *AIFM* is responsible for calculating the net asset value under *FUND* 3.9.2R (see question 1.12).

Article 19 of the AIFMD covers the "proper and independent **valuation** of the **assets** of the AIF" and the "**calculation** of the **net asset value** per unit or share of the AIF". We are concerned that the proposed answer to question 1.4 goes beyond this requirement and would cause confusion in practice on the extent to which the valuation requirements apply to liabilities and items which are not complicated to value.

If the intention is to incorporate investments in instruments that may have a negative value, the first two paragraphs of the answer could be clarified as follows:

> The valuation function involves valuing the assets of an *AIF* which are ~~all investments~~ held in the *AIF*'s investment portfolio. This would also include ~~is regardless of whether the~~ portfolio investments ~~constitute~~ which are classified as ~~assets or~~ liabilities.
>
> Therefore, positions in derivatives or short positions, as well as other investments which have a negative value or are held at a loss, and are part of the investment portfolio of an *AIF*, ~~and~~ should be valued as part of the valuation function.

The third paragraph of the answer could be interpreted to extend the application of Article 19 to non-investment assets and liabilities. This would be disproportionate as such items are usually expected to be settled in the short term and have a fixed, easily identifiable value e.g. general creditors for expenses or management fees payable and assets such as cash balances. We do not believe this is your intent and propose that the paragraph is amended to make clear that the "proper valuation" required for balance sheet items which are not investments does not form part of the "valuation task" and nor is it within the remit of the valuation function. This paragraph could be clarified as follows:

> The proper valuation of all the liabilities of an *AIF* is needed to calculate the net asset value of the *AIF*. This includes valuing liabilities which are ~~not~~ non-investment~~s~~ items ~~so are not required to be valued as part of the valuation function~~, such as management fees and accruals. The valuation of non-investment liabilities does not form part of the valuation task and is not within the remit of the valuation function.

Question 1.7: When will an AIFM's valuation function be functionally independent from its portfolio management?

The valuation function of an *AIFM* will be functionally independent from its portfolio management when the individuals performing the valuation function:

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(1) are not engaged in the performance of activities within the portfolio management function;
(2) are not directly supervised by those responsible for the performance of the portfolio management function of the *AIFM*; and
(3) are compensated in accordance with the achievement of the objectives linked to that function, which should not be substantially dependent of the performance of the portfolio management function.

We believe the answer to question 1.7 goes beyond the requirements of Article 19(4) (b) in Level 1 of the AIFMD and sets a higher threshold for UK AIFMs performing the valuation task to be considered to be functionally independent from portfolio management. **We believe it would cause significant practical difficulties and prove much more restrictive than the Level 1 text intended**. In our view, this will effectively require hierarchical independence given the seniority of the individuals needed to perform the valuation function. Question 1.7 should be removed from the Q&A in its entirety as question 1.10 addresses the involvement of portfolio managers.

The valuation of assets in PE/VC funds is a complex area as valuing investments in unquoted companies requires in-depth knowledge about the company and the industry and markets in which it operates. To perform the valuation of these types of assets robustly and effectively, full scope UK AIFMs managing PE/VC funds are generally electing to perform the valuation function themselves. This approach has not only been accepted by the FCA as part of the AIFMD authorisation process, but is a long-standing industry approach to valuation, as agreed between PE/VC fund managers and their investors and auditors.

In addition, well-established industry guidance on valuations, which has involved substantial input from the wider industry and investors over many years, does not require valuations to be carried out independently. This guidance includes the International Private Equity and Venture Capital Valuations Guidelines and the Institutional Limited Partners Association Private Equity Principles. At the same time, policies and procedures have been established by PE/VC firms to ensure these valuations are performed impartially and independently to the extent necessary based on an assessment of the conflicts of interest involved. This is alongside the high expectations set by investors and the review of effectiveness of controls and processes in place as part of the annual external audit.

Article 19(4) (b) states that the valuation function can be performed by the AIFM itself, "provided that the valuation **task** is functionally independent from the portfolio management and the remuneration policy and other measures ensure that conflicts of interest are mitigated and that undue influence upon the employees is prevented". Our comments are based on how your proposed answer fits with the different limbs of this article.

The framing of question 1.7: As noted above, we would suggest that question 1.7 is removed in its entirety.

Condition (1): This will be impractical to implement in many cases without significant, additional expense.

- As part of their governance procedures, PE/VC AIFMs will typically approve valuations at the level of a valuation committee which is likely to include individuals engaged in the performance of activities within the portfolio management function. However, these individuals will not control the decisions of the committee.

- The factors impacting the valuation of PE/VC investments are generally specific to that particular company. By the very nature of the task, those individuals within a PE/VC firm that have portfolio management skills are often the same individuals that have the most appropriate mix of skills and experience to comprise the valuation committee. Therefore we believe it is sufficient for a PE/VC firm to demonstrate that the valuation task is functionally independent from portfolio management, the decision of the valuation committee is not controlled by the portfolio management function and that conflicts of interest are appropriately mitigated (see our response to condition (3) below).

- The costs of involving external valuers will be prohibitive as PE/VC investments do not generally share attributes with other asset classes that would facilitate a valuation by an external valuer. For example, other asset classes such as property where rental income, age and condition, and prevailing rents for a similar building can all be easily established and assessed for the purpose of valuation by an external valuer with no prior knowledge of the building. Furthermore, for unquoted companies, detailed information will need to be collated from the AIFM as these companies will have fewer public reporting requirements and these will not be at the frequency or detail required.

Condition (2): Article 19(4) (b) requires only functional independence of the valuation task rather than functional **and hierarchical** independence (which could have a significant impact on the eligibility of an AIFM to perform the valuation role).

- Condition (2) will be very restrictive, if not impractical, to comply with in practice as we expect there will be individuals performing the valuation task that are directly supervised by those responsible for the performance of the portfolio management function, even if for the purposes of performing the valuation task they report directly to a CFO or another individual not engaged directly in portfolio management.

- This condition also assumes that all members of the valuation function will not be directly supervised by those responsible for the performance of the performance of the portfolio management function. This is unlikely in a small, owner-managed, asset management business including many operating in the PE/VC industry, particularly where the governing body is responsible for the performance of the portfolio management function. The alternative would be to delegate the valuation task to more junior members of the team who would not have the requisite experience and in practice it will be difficult to identify other senior candidates in the AIFM who could perform this task.

- This point is recognised in the AIFMD, for example in Article 42(2) of the Level 2 Regulation which applies to the functional and hierarchical separation of the risk management function. Notwithstanding the different level of separation required for the risk management function compared to the valuation task, this paragraph

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requires separation "throughout the whole hierarchical structure of the AIFM, up to [*our emphasis – but implicitly stopping at]* its governing body."

Condition (3): This is also disproportionate in the context of PE/VC AIFMs, particularly when they are small and the potential for conflicts of interest is lower.

- The purpose of functional independence is to mitigate – rather than prevent – conflicts of interest. AIFMs therefore need to identify the conflicts of interests that are present, demonstrate how these are mitigated, and then establish functional independence which is proportionate to the identified conflicts of interest and the risk of them occurring.

- Conflicts of interest with respect to valuation depend on a variety of factors and will vary between different asset classes. In the context of PE/VC funds, valuations do not affect returns to investors and do not generally have an effect on management fees charged as these are typically based on commitments from investors which are a fixed amount (and reduce in the latter years of a fund's life, typically based on capital invested in the remaining investments). Furthermore carried interest, the main incentive for PE/VC managers, is generally calculated by reference to realised gains rather than interim valuations (although this may not always be the case) and would have been agreed with investors upfront. These two factors reduce the potential for conflicts of interest when valuing assets and also link into the AIFM's remuneration policy i.e. an employee has no incentive to overstate a valuation for personal gain. However, conflicts of interest may arise in other situations and should be considered by the PE/VC firm on a case-by-case basis.

In the context of PE/VC AIFMs, conflicts of interest regarding valuations are typically managed and mitigated in a number of ways including:

(i) a limited partner (investor) advisory committee will often be established and be responsible for reviewing conflicts of interest when they arise (and this committee will comprise of sophisticated investors). This committee may also take an interest in valuations and be well placed to challenge AIFMs on valuation processes e.g. monitoring realised values against interim;

(ii) review by external auditors of valuation policies and procedures and year end valuations as part of an AIF's audit process. The auditors are required to report on their findings each year to those charged with governance and this includes comments on the valuations process itself. In addition to this, depositaries also review the processes in place as part of their own ongoing responsibilities;

(iii) a remuneration policy that does not take into consideration valuations (see above);

(iv) a valuation committee which approves the valuations and has a policy that ensures individuals that are portfolio managers on that committee act only in an advisory capacity for the specific investments they are responsible for. The governing body of the PE/VC firm will ultimately be responsible for ensuring that the valuation committee and the other individuals performing the valuations task have the requisite skills, experience and impartiality to perform their functions; and

(v) in the absence of a valuation committee, ensuring that the executive(s) responsible for approving the valuation for an individual asset is not involved in the portfolio management of that asset.

In their policies and procedures, AIFMs are required (under Article 67(4) of Level 2) to document the safeguards in place to prevent or restrain inappropriate influence. This principles-based approach clearly requires the level of functional independence to be determined by reference to the conflicts of interest that are applicable to the AIFM and the assets of the AIF. A key determinant will be the extent to which management and performance fees, and linked to this, remuneration policy, are based on valuations.

Where the risk of conflicts of interest is low, e.g. in PE/VC AIFMs with effective carried interest schemes in place, the threshold for achieving functional independence is expected to be proportionate and could include the procedures outlined above ((i) to (v)). The governing body/AIFM board is ultimately responsible for the performance of the valuation function and ensuring the requirements around functional independence are met. This could include ensuring voting decisions on valuations and the assessment on conflicts of interest are properly documented.

Where the risk is increased, this may require further procedures to enhance functional independence, e.g. the involvement of senior executives who report directly to the AIFM's governing body and are not supervised by those responsible for portfolio management.

We believe these areas are already adequately addressed in the Directive and in question 1.10 so question 1.7 should be deleted in its entirety.

Question 1.10: Can the AIFM's portfolio managers (or the portfolio management delegates where appointed) provide input to the person undertaking the valuation function?

The *AIFM* must ensure that the valuation of the *AIF*'s assets is performed impartially. This means that individuals undertaking portfolio management for the *AIF* (either at the *AIFM* or a delegate of the *AIFM*) may not make the final determination of an *AIF* asset's value.

However, for some portfolio assets, individuals undertaking portfolio management may be a useful source of advice for the *person* undertaking the valuation function.

The *person* undertaking the valuation function (either *AIFM* or *external valuer*) may accept the advice of individuals undertaking portfolio management for an *AIF* on the value of individual assets if it:

(1) is not bound to accept the portfolio manager's recommended values for particular assets;
(2) makes reasonable efforts to independently verify the price recommended by the portfolio manager; and
(3) is competent to form an independent view on whether the portfolio manager's recommendation is reliable.

The *AIFM* also needs to ensure that the valuation policies and procedures specify:
(1) when the *person* performing the valuation function may seek the advice of portfolio

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managers;
(2) the controls in place to ensure there is an appropriate degree of objectivity in finalising values; and
(3) the review process for the individual values of the assets (see article 71(2)(f) of the *AIFMD level 2 regulation*).

If a valuation committee which includes portfolio managers makes the final determination of an asset's value, the portfolio managers must:
(1) participate in an advisory capacity only;
(2) not exert undue influence on final valuations; and
(3) not have a vote on the final asset values.

In such cases, the voting members of the committee should collectively have sufficient seniority and competence to form an independent view on whether the portfolio managers' recommendations are reliable.

The answer should refer to assets that are part of an AIF's investment portfolio, therefore making it clear that the requirements only apply to these types of assets and not all assets in general. This also applies to the answers to questions 1.2, 1.3, 1.5 and 1.9.

As outlined above, many of the PE/VC firms that fall within the scope of the AIFMD are relatively small, owner-managed businesses and it is possible that a number of individuals involved in the portfolio management function will also sit on the valuation committee. It is therefore important that the penultimate paragraph in the answer to question 1.10 is not unduly restrictive.

We would suggest the following amendments to the first and penultimate paragraphs to ensure the composition of the valuation committee still includes experienced members.

> *First paragraph:*
>
> This means that individuals undertaking portfolio management for the *AIF* in relation to an *AIF* asset (either at the *AIFM* or a delegate of the *AIFM*) may not make the final determination of ~~an~~ that *AIF* asset's value.
>
> *Penultimate paragraph:*
>
> If a valuation committee which includes portfolio managers makes the final determination of an asset's value, the portfolio managers must:
>
> > (1) participate in an advisory capacity only with respect to the specific asset(s) they are responsible for;
> > (2) not exert undue influence on final valuations; and
> > (3) not have a vote on the final asset values of the specific asset(s) they are responsible for.

Effects of article 72AA of the RAO on AIFMs

Q4.2: Do you agree with our proposed notification requirements for firms carrying on activities under the RAO exclusion in connection with, or for the purposes of, managing an AIF?

Q4.3: Do you have any comments on the proposed notification form?

In paragraph 4.13 of the consultation paper, the FCA states that it does not expect that the exclusion in Article 72AA of the Regulated Activities Order ("RAO") (the "Article 72AA exclusion") is widely used by AIFMs. In our experience, it is fairly common for AIFMs managing private equity funds to rely on this exclusion when establishing and operating employee carry and co-investment vehicles (which are usually collective investment schemes, but not AIFs) in connection with the AIFs managed by them. In the absence of the Article 72AA exclusion, it is likely that such AIFMs would need to have Part 4A permission for establishing and operating a collective investment scheme under Article 51ZE RAO.

In our view, reliance on the Article 72AA exclusion for these purposes clearly does not raise the same consumer protection concerns as, for example, an AIFM that carries on consumer credit activities in reliance upon the exclusion. The establishment and operation of such vehicles is an integral part of the broader management of the AIF and the participants in such vehicles will be individuals of the type described in PERG 16.2, Questions 2.34 and 2.35. We assume that the notification requirement in the proposed FUND 1.4.8R(1) was not intended to apply to AIFMs who are using the Article 72AA exclusion for these purposes, but the current drafting could be interpreted as requiring such AIFMs to submit a notification in this situation. We would therefore request that the FCA clarify that AIFMs will not fall within scope of the proposed provision where they rely on the Article 72AA exclusion in connection with employee carry and co-investment schemes.

We also note that in the list of activities in the proposed FUND 1.4.8R(2) which are not subject to the notification requirement, the drafting refers to the activity of arranging (bringing about) deals in investments under Article 25(1) RAO, but does not include the broader activity of making arrangements with a view to transactions in investments under Article 25(2) RAO. We assume that both arranging activities were intended to be included in the proposed list of activities that are not notifiable.