James Ferris
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By email: AAT@frc.org.uk

27 September 2019

Dear James,

Re. Consultation on Revisions to the Ethical and Auditing Standards 2019

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 750 firms, the BVCA represents the vast majority of all UK-based private equity and venture capital firms, as well as their investors and professional advisers. Over the past five years (2014-2018), BVCA members have invested over £38bn into nearly 2,800 companies based in the UK. Our members currently back around 4,330 companies, employing close to 1.6 million people on a full-time equivalent basis ("FTEs") across the world. Of these, around 843,000 FTEs are employed in the UK. Of the UK companies invested in during 2018, around 87% were SMEs.

This submission has been prepared by the BVCA's Legal & Accounting Committee, which represents the interests of the BVCA members in legal, accounting and reporting matters relevant to our industry.

Overall, we support measures to improve quality and independence in the audit market. However, we are strongly concerned with the introduction of a rather limited list of permitted services that can be provided by auditors of Public Interest Entities (PIEs) and the expansion of the requirements to certain non-PIEs. We believe such changes will significantly reduce the choice of accounting firms to provide services to private equity and venture capital (PE/VC) firms, without materially reducing the threat to audit independence and without there being a broader public interest in doing so. This situation arises because of the structure of PE/VC funds and the way in which they invest in and manage businesses. The restrictions apply in a more complicated manner to these types of structures than corporate groups and this in turn can have unintended and burdensome consequences such as delays to a transaction timetable to address independence requirements. This is not only detrimental for PE/VC firms and the investment process, but also the investors (including pension funds, family offices and foundations) into PE/VC funds through additional compliance costs required and the financial impact of delayed transactions. It is crucial that any overall package of reforms maintains audit quality and independence, whilst ensuring the UK remains an attractive place to do business, particularly in light of the current economic and political outlook.

We have limited our responses to those questions that we believe are of particular relevance to our members.

Background to Private Equity and Venture Capital

PE/VC firms are long-term investors, typically investing in companies for around 5-7 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 on the public markets or selling to a strategic buyer.

PE/VC firms typically use a limited partnership to structure funds. Appendix 1 sets out an example fund structure and shows the different firms that may be involved throughout. The general partner of the 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.

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 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 companies ("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. 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. 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.

Most PE/VC firms are not themselves PIEs. However, the funds may have investments in companies that meet the definition of a PIE, so PE/VC firms do need to consider the impact of the restrictions per the Ethical Standards. For example, there may have been a partial exit through an IPO of a portfolio company so the fund has a stake in a listed company/PIE.

As the example per Appendix 1 illustrates, a number of different audit firms may be involved with the audit of the different entities in the private equity structure. In this example, due diligence services or corporate finance services (currently permitted non-audit services) have been procured from an audit firm by the fund manager as part of the acquisition of a portfolio company.

There may be other listed securities (debt) that do not meet the definition of an EU PIE. For example:

- The portfolio company has issued high yield bonds (being bonds with a lower credit rating than investment grade bonds and which therefore have a higher yield to reflect the higher risk of default), which are typically listed on the Luxembourg Euro MTF or the Irish GEM exchanges, both of which are 'recognised' but not 'regulated' markets.
- The fund has provided funding through interest bearing loans (often referred to as shareholder loans), which are commonly listed on a stock exchange recognised by HMRC, in particular The International Stock Exchange ("TISE"), but which are in fact not traded as the loans are held entirely by the private equity fund. Again, the TISE is a 'recognised' but not 'regulated' market.

Given that these securities are not typically held by members of the public, nor are they traded, we are in agreement with the position previously taken that companies which issue such notes are not, and should not be classified in the future as, PIEs.

Responses to Consultation Questions

4.	**Do you agree with the introduction of a permitted list of services which the auditors of PIE audits can provide?**

The reasoning behind the introduction of a permitted list of services to provide greater clarity on the non-audit services that may be provided by firms that are also providing audit services is understood by the BVCA. However, the permitted list does not include certain non-audit services where there is minimal threat to audit independence, especially transaction services and sell-side corporate finance services. This will seriously affect the efficient functioning of capital markets and significantly restrict the choice of service providers for PE/VC firms.

The permitted list of services currently does not clearly permit private reporting accountant work for PIEs issuing equity or debt or undertaking any major corporate transaction which requires shareholder approval. Due diligence, private opinions, comfort letters and agreed upon procedures should all be clearly permitted. If this is not the case, there would need to be a substantial change to the capital markets process and causing disruption for market participants.

We understand that it is the intention that the provision of comfort letters will still remain permissible services. This is important because it represents an example of certain services, such as prospectus comfort letters in relation to debt market fundraisings, where the auditor is much better placed to provide such services. In addition to being more costly and inefficient, we believe prevention of such non-audit services would be disruptive to the point of becoming unworkable.

We would also note that if the FRC is content to continue to permit reporting accountant work and due diligence to be carried out by accounting firms that also audit the PIE in line with all other global markets, it is essential that the key drafting changes are clear and understandable so that firms, audit committees and other stakeholders can be confident and consistent in their application of the revised standards. We are concerned that the proposals will be detrimental to the competitive position of the UK within the global economy and that they will be unworkable in practice for the audit committees and boards of our members.

The outright prohibition of contingent fees for non-audit services is also concerning for our industry in situations where there is a minimal threat to audit independence and objectivity, for example the provision of sell-side corporate finance advisory services when selling a portfolio company. (This is notwithstanding that such services are currently not included on the permitted list for public interest entities, whether on a contingent fee basis or otherwise.) The consultation paper notes that the self-interest threat where a fee is contingent on a particular outcome is too great to be mitigated, however we do not believe there is such a threat in this situation.

Ultimately this again will restrict the choice for PE/VC firms, when seeking provision of non-audit services. Firms will either forgo non-audit service provision by one or more accounting firms if they provide audit services to the firm or any of its portfolio companies, or will frequently have to change auditors of the various entities within its structure. This is neither in the interests of the investors of the PE/VC funds, nor is there a broader public interest in doing so.

Finally, we are also concerned with the proposed extraterritorial reach of the standards with member firms of a global accounting network apparently also unable to provide non-audit services other than the “permitted” services to the parent undertaking(s) and controlled undertakings of a PIE, wherever they may be in the world. Notwithstanding the practical challenges and cost in monitoring, this may again severely restrict choice for PE/VC firms, particularly in geographies where there may be few appropriately experienced service providers, who themselves may be in a completely different member firm structure than the auditor and therefore the impact on independence is reduced even further.

5. Do you agree with the additional prohibitions we are proposing to introduce – in learning from the experience of enforcement cases like BHS, if the more stringent PIE provisions are to have a wider application to non-PIE entities, which entities should be subject to those requirements?

We understand why the FRC is exploring expanding the PIE requirements in respect of the non-audit service provisions to a wider group of non-PIEs. However, we are strongly concerned with the prohibitions being extended to a wider group of non-PIEs, before the FRC has even consulted on and proposed what sort of entities would be included within this new category, as this will create significant and unnecessary uncertainty. Additionally, any changes should not be introduced at such short notice (see response to Q13). We would also argue that only the enhanced auditing standards applicable to PIEs are extended to any non-PIEs, rather than also the application of the non-audit services prohibitions, which do not directly improve audit quality.

Our concerns focus first on the potential restrictions on choice and quality of service provider that could occur if the scope were to be extended. These concerns arise due to, and are compounded by, the transaction-driven nature of our industry and management of controlling stakes in portfolio companies through fund structures. As discussed above, fund structures are very different to typical corporate group structures and there is considerable complexity involved in analysing audit and adviser relationships, also noting that this extends beyond the 'Big 4'. Furthermore, this only exacerbates the issues we have noted in our response to Q4 in creating a limited list of permitted services, which cannot be provided on a contingent fee basis. Service provider choice will be severely restricted, which is critical for a fast-moving transaction focussed industry and does not seem in the public interest in a broader sense.

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. This is illustrated in appendix 1. 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. As a result, if the PIE restrictions on non-audit services are widened to non-PIEs, it would be common for PE/VC firms to have several portfolio companies that are audited by different audit firms. 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). 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 is particularly disproportionate for non-PIEs many of whom are owner managed and will rely on outsider expertise to run their businesses. This conflicts with PE firm's obligation to seek support and advice from most relevant and appropriately experienced advisors.

Additionally any extension in the application of the ethical principles and supporting specific requirements to non-PIEs will create further inconsistency in how the rules work between the UK and

EU Member States. This will just add to the complexity for companies and their directors where so many groups have cross-border considerations, notwithstanding the complexities that Brexit may create (for example, companies incorporated in one country but with securities listed in another).

6. Do you agree with the removal of the reliefs for SMEs in Section 5 of the Standard, and the retention of reliefs for 'small' entities (in Section 6 of the Standard)?

We do not agree with the removal of reliefs from certain FRC ethical requirements for SME listed entities and believe these should be maintained as it is not clear what the public interest benefit is for removing such reliefs.

13. We are proposing changes to the standards to be effective for the audit of periods commencing on or after 15 December 2019. Do you agree this is appropriate, or would you propose another effective date, and if so, why?

As per our response above, some of the proposals as they currently stand will have a significant impact on our members when undertaking their investment activities. We are concerned that if the proposed changes to the standards are brought into force at such a short notice, this will not allow sufficient time for our members to plan and comply with any changes. More broadly it will likely cause significant disruption to the markets. This is brought more to the light considering the current economic and political climate. We strongly suggest that the effective date is pushed back and an appropriate transition period is introduced. We would also suggest that any changes are delayed until the findings of the Brydon review into audit and the government's consideration of the CMA review has been published to avoid unnecessary confusion and disruption for market participants.

The BVCA would of course be willing to discuss this submission with you further and, if you so wish, please feel free to contact Gurpreet Manku (gmanku@bvca.co.uk) at the BVCA.

Yours sincerely,

Amy Mahon
Chair, BVCA Legal and Accounting Committee

Appendix 1

The diagram below is a PE/VC limited partnership fund structure for illustrative purposes only.