Becky Young
Competition Division
Financial Conduct Authority
25 The North Colonnade
London E14 5HS

By email: assetmanagementmarketstudy@fca.org.uk

20 February 2017

Dear Becky,

Re: BVCA response to Asset Management Market Study Interim Report (MS15/2.2)

About the BVCA

1. We are writing on behalf of the British Private Equity and Venture Capital Association ("**BVCA**"), 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 600 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. Our members have invested over £27 billion in nearly 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 385,000 people and 84% of UK investments in 2015 were directed at small and medium-sized businesses.

2. We note that private equity and venture capital managers were specifically scoped out of the market study. We therefore understand that they are outside of the scope of the preliminary findings, except for the commentary relating to transparency of fees and charges specifically mentioning our sector. For this reason, our response is limited to that issue.

3. We summarise below the industry-led efforts in our sector to (i) improve understanding about the nature of fees and charges in private equity and (ii) enhance and standardise disclosures provided to investors. The BVCA is of the view that in light of these efforts, it would not be appropriate for the FCA to impose an additional standardised disclosure framework. This would introduce an additional layer of reporting and increase complexity.

4. We have previously met with the FCA investment management sector team to discuss practice in the industry and would be delighted to meet you to discuss this area in further detail.

The nature of private equity funds

About the private equity and venture capital industry

5. Private equity and venture capital firms are long-term investors, typically investing in unquoted companies for around three to seven years. Private equity and venture capital managers generally exercise a great level of influence over the businesses they own, and undertake important strategic and operating initiatives to create value and enhance the

performance of businesses owned. Such initiatives can include expanding the product portfolio or geographic reach of businesses, acquisitions to strengthen the market positioning and achieve economies of scale, cost controls, process improvements and other operational efficiencies. There is a commitment to build lasting and sustainable value in business and as a result strong returns for investors in private equity and venture capital funds as described below.

6. The UK is a global hub for venture capital and private equity and our members have demonstrated their consistent ability to outperform other asset classes. On a since-inception basis, UK funds returned 13.8% (net of fees) in 2015, and the 10-year IRR generated 13.2% (net of fees), nearly double that of pension fund assets and the FTSE All-Share Index.[1]

7. Investors in private equity and venture capital funds are typically institutional investors. This includes pension funds, university endowments, insurance companies, sovereign wealth funds, fund of funds, corporate investors and private individuals. Further detailed information on the investor base can be found in our annual survey[2]. Additionally, private equity and venture capital funds are typically closed-ended funds with a long term (typically ten years with the ability to extend) investment period. As a consequence, private equity managers often have a close and long standing relationship with their investors. The constitutional arrangements of the fund are heavily negotiated with legal advice sought by both the manager and investor. The resulting agreements are detailed and set out the need for regular reporting. In addition to this, investors will receive tailored reporting on request to meet their specific needs (for example if they themselves are regulated or supervised).

8. Appendix 1 sets out further detail on how private equity funds are structured including details about fees and charges, carried interest and co-investment.

Active managers

9. The FCA's report is critical of some managers which brand themselves as "active", on the basis that the FCA believes many of these managers are passively 'hugging' market indices. A number of the FCA's concerns appear to stem from this issue. We note that private equity and venture capital managers are always "active" managers. This is because of the way they invest: through acquiring large stakes in unlisted companies. Private equity fund managers cannot passively 'hug' an index when making investments because no such index exists.

Publications and education

10. Our membership includes nearly 100 investors in private equity and venture capital and we have undertaken research and published educational reports to provide further information to investors and other stakeholders.

11. Our most recent reports include:

    a. Examining Private Equity's Place in Investor's Portfolios - This report looks at how and why investors invest in private equity and includes commentary on fees and reporting.

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[1] BVCA Performance Measurement Survey 2015 – available here

[2] BVCA Report on Investment Activity 2015 – available here

b. Risk in Private Equity – This report explores and analyses the different types of risk that can affect private equity investments.

12. The BVCA also sponsored a guide for pension funds interested in the asset class. This is available on the Pensions and Lifetime Savings Association's website and provides a simple, easy to follow guide to the asset class, including detail on the approach to fees and reporting.

The level of transparency of fees and charges relating to investments in private equity

13. The BVCA is supportive of the need to promote and enhance transparency in the private equity industry. Detailed reporting on the fees and carried interest earned by fund managers is increasingly being sought by investors. The industry has over recent years taken, and continues to take, steps to demonstrate best practice in reporting to investors.

14. Investors can and often do request and receive detailed information from private equity and venture capital fund managers on fees and charges. This includes quarterly reporting and ad-hoc requests as well as audited annual financial statements. The allocation of costs between the fund and the fund manager is covered in fund agreements that are heavily negotiated by sophisticated investors.

15. **We have helped develop principles-based guidance when reporting to investors, which we encourage our members to follow. This allows firms to tailor their reporting to meet investors' needs, which may differ due to the global nature of their investor base.**

16. Invest Europe, the pan-European private equity trade body, undertook an exercise in 2015 to update its **investor reporting guidelines**. The exercise included representatives from both the fund manager and investor community and its proposals were widely circulated to its members for consultation.

17. The 2015 edition of the investor reporting guidelines[3] include recommendations on fee reporting. This includes the required detail of breakdown between the types of fees that fund managers earn. It also indicates to what extent fees paid by investors ought to be reduced by amounts earned directly by managers through fee offset arrangements.

18. The guidelines cover the carried interest earned by fund managers and whether the fund has a hurdle rate that will apply before carry is paid. The guidance also requires the fund to provide an analysis of how much carry has been paid in cash, whether it is subject to clawback or whether there are escrow arrangements. In addition, the investor reporting guidelines also provide guidance on best practice disclosure of third party fees (such as administrators, consultants and auditors).

19. Rather than prescribe a standard template, the Invest Europe guidelines sets out best practice for required disclosures and possible additional disclosures. The guidelines are accompanied by illustrative disclosures.

[3] The Invest Europe Investor Reporting Guidelines are included in Section 5 of the Invest Europe Professional Standards Handbook – available here.

20. The Institutional Limited Partners Association ("ILPA") has also implemented a **Fee Transparency Initiative**, which led to the development of a reporting template[4] that captures greater detail on fees, expenses and carried interest paid to general partners (who manage private equity funds) and their affiliates. This is an industry-led, global initiative that was completed in 2015 and involved investors, private equity firms and administrators. ILPA also states that "the aim of this template is to encourage increased uniformity in the disclosures being provided to LPs. This will benefit the industry in two ways:

    a. Providing LPs with an improved baseline of information that lends itself to more streamlined analysis and informed internal decision-making.

    b. Reducing the compliance burden on GPs, who face a variety of bespoke template formats.

21. The BVCA made representations during the consultation phase and these are recognised in the guidance accompanying the template and its format. ILPA acknowledged that investors will need to consider "the size, back-office resources, operating budgets, and complexity of the funds managed by their GPs when determining their requirements for Template compliance." There is therefore scope to tailor the requirements to meet the needs of both investors and firms alike given the granularity of information requested, which may be difficult and costly for some smaller managers to collect, collate and provide if the required systems and processes are not in place.

22. **Given this backdrop, it would be onerous and duplicative for another standardised template to be developed by the FCA for institutional investors. The BVCA is of the view that industry-led initiatives that involve investors and private equity firms, such as the Invest Europe guidelines and ILPA template, are a better solution to address concerns over transparency.**

23. We should also note that there are already detailed requirements in the AIFMD[5], and looking ahead there will be further requirements under PRIIPs and MiFID II. The FCA must have due regard to the reporting requirements in these directives and regulations before introducing any new requirements. Any additional reporting burdens would also hamper the UK's competitiveness as a destination for asset management. This must be borne in mind as the UK prepares to leave the EU.

Other comments on the findings in the Interim Report and related matters

24. We welcome the fact that the Interim Report recognises the distinction between the "institutional investor" market and the "retail investor" market in the asset management sector. Although the Interim Report does not define these markets by reference to existing regulatory concepts, existing regulatory categories of investor do not serve to categorise investors in private equity and venture capital funds adequately given the long-term nature of the industry. We have previously commented on this issue in our correspondence with the FCA and do so again here in case it is helpful when considering future approaches to

[4] Further detail on the initiative and the reporting template is available here

[5] Rules on pre-investment disclosures, "treating investors fairly" and "preferential treatment" apply where the firm is a full-scope UK AIFM. Non-EEA AIFMs marketing into the UK (or other EEA Member States) under Article 42 of the AIFMD are also subject to the pre-investment disclosure rules

categorising investors.

25. Prior to the introduction of MiFID, the UK's approach to classifying professsional clients was relatively neutral as between the types of investments made by those clients (be they liquid or illiquid). Following the introductoin of MIFID, the UK was required to amend its approach to opting up clients to "professional client" status to follow the MiFID approach. This approach was then adopted in AIFMD. It inherently favours liquid investment and is not sufficiently tailored to take into account the nature of investment in private equity and venture capital asset funds. MiFID II will carry that approach forward. Our particular concerns with the quantitative element of the opt-up test are:

    a. The first test (‘frequency’) is calibrated for participants in liquid markets such as those for exchange-traded equities but applies also in other contexts such as the marketing of interests in private equity funds. Not even the most seasoned institutional investors, with an active private equity investment programme, make as many as 10 commitments per *quarter* to private equity funds. The largest investors will typically build portfolios of say 20-40 private equity fund managers over a number of *years* in order to spread vintages and manage cash-flows.

    b. The third test (‘expertise’) may be met by some investors but not by new entrants (such as serial entrepreneurs who decide to invest into a fund for the first time). Most high net worth individuals and business angels as well as entrepreneurs will not have worked in the financial sector, but are very well suited to invest in venture capital and private equity funds, bringing with them both capital and expertise in building companies.

    c. As a result, despite their level of wealth and/or their often sophisticated investment strategies many high net worth individuals will not meet the “professional upon request” criteria in MiFID (the “two out of three” quantitative test) and will usually be treated as ‘retail investors’ under MiFID (and consequently also under the AIFMD and other legislation that cross-refers to this definition).

    We and others have raised additional concerns regarding the application of the MiFID II opt-up test to Local Government Pension Schemes.

Additional concerns

26. The proposed remedies to amend governance arrangements (such as the need for independent board members and chairs, etc) are not suitable for privately-owned and small asset managers, such as private equity and venture capital firms, as they would not be practical to implement. Appendix 1 explains the mechanisms in place in the private equity and venture capital model to ensure alignment of interests between the manager and investors.

Conclusion

27. The BVCA welcomes the FCA's Interim Report from its Market Study which highlights the importance of active management for investors. The private equity and venture capital industry provides truly active management and has provided strong returns for investors.

28. The BVCA would welcome the opportunity to discuss the industry-led initiatives to educate investors about the private equity and venture capital industry as well as existing industry-led initiatives to provide greater transparency about costs and charges.

29. The BVCA welcomes the FCA's recognition that the asset management market is split between retail and institutional investors. Private equity and venture capital funds are targeted at institutional investors.

We would be very keen to discuss the contents of this letter further with you and please contact Gurpreet Manku (gmanku@bvca.co.uk) at the BVCA to arrange a meeting.

Yours sincerely,

Tim Lewis
Chair, BVCA Regulatory Committee

Appendix 1 – Explanation of a private equity fund structure

Investors in private equity funds are almost universally institutional (professional) investors. A private equity fund structured as a limited partnership is created through negotiation between investors (the "limited partners") and their legal advisers and the private equity manager (also known as the "general partner"). This results in a governing document (for example, the limited partnership agreement) that sets out the key terms of the fund. The private equity group owns the general partner (one of the partners in the fund) and the fund manager, which manages the fund. In some cases, the general partner and fund manager are a single legal entity.

Investors make commitments to invest in the fund, i.e. the amount they originally agree to subscribe to the fund. The amount committed is not paid immediately on a fund's closing but in tranches over the commitment period on an "as needed basis" (typically four to seven years). Investments in private equity funds are generally held until the fund is wound down at the end of its life.

Investments

The fund invests in a number of unlisted portfolio company operating groups, typically aiming for a measure of diversification by geography, sector etc.

In many cases, the fund will take a controlling position in the equity of the holding company (but this varies between private equity and venture capital strategies). Members of the management team of the portfolio company will often also have a shareholding, in order to incentivise them.

Third party banks may lend to each portfolio company group. There is typically no cross-collateralisation or exposures as between one portfolio company group and any of the others. Each investment is in its own silo, separated from the others.

Fees and charges

Pursuant to the constitutional documents of the fund, the private equity group receives a fixed annual amount for managing the fund. This is often structured as a fee charged by the fund manager to the general partner, who pays the fee out of its priority profit share received from the fund ("PPS" or "management fee"). Any increase in risks and the valuation of the fund does not increase the amount of management fee, so there is no incentive to increase these risks. Private equity managers must therefore carefully budget to ensure their cost base is covered by the PPS.

The PPS/management fee is intended to cover the overheads of the general partner and fund manager, including e.g. salaries, office rents, etc.

Transaction/arrangement fees may also be levied by the manager in connection with completed investments. These fees are typically offset against the management fee paid by investors and in recent times this has increasingly led to the offsetting of the whole amount. Monitoring fees earned by the manager relate to the ongoing portfolio management of the target company as executives from the manager will often sit on its board. Other fees such as exit fees may also be charged.

BVCA

Appendix 1

Fund profitability

Profits are achieved by the fund only on a successful realisation of the fund's investments, which might arise on the sale of the portfolio company or following proceeds received as a result of its initial public offering on a listed market. Fund profits for the purpose of paying out distributions are therefore realised and real (as opposed to being based on accounting valuations). Typically, proceeds received by a fund are distributed in a timely fashion to investors and are not held within the fund pending a fixed distribution date sometime in the future.

As each of the fund's investments are sold, once any outstanding fees and expenses of the fund have been paid, investors are first repaid all the money drawn down from them in full, plus the agreed preferred return. Only then is the agreed percentage of any generated profits of the fund paid-out in carried interest to the manager and its executives.

Carried interest

Carried interest is a basic element in private equity fund structures. The detailed terms of a particular fund's carried interest structure are agreed by the investors and fund managers and set out in the fund's constitution document. To ensure alignment with investor interests, investors expect key members of the investment team at the private equity group to be part of the carried interest based arrangements. They typically also expect to see a co-investment obligation from these team members. Commercially, investors would prefer to see the firm founders allocate as much personal wealth as is available to co-investment, as opposed to allocating that wealth to regulatory capital in the manager or its group.

Investors must receive back from the fund in cash an amount equal to their drawn down commitments (the amounts they actually pay in to the fund at the time the distribution is being made) plus a preferred return on this amount. Only then does the carried interest vehicle start to participate in a percentage of the profits. After this preferred return has been reached, profits are allocated in accordance with a pre-determined formula agreed with investors and set out in the fund constitutional documents. In other words, carried interest operates on a cash to cash (realised profits only) basis. It does not pay out based on accounting valuations.

Co-investment

Co-investment by private equity executives may be negotiated between investors and the manager to promote alignment of investor interests and to ensure that the investment team has "skin-in-the-game" alongside investors. In other words, they put at risk the loss of their own money through their stake.

There is no common method by which the co-investment is funded. It will depend on the particular circumstances of the prospective participants and the level of the commitment.