Paul Rich/Hillary Neale
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

By email: cp21-07@fca.org.uk

28 May 2021

Dear Mr Rich, Ms Neale

Re: BVCA Response to FCA CP 21/7 A new UK prudential regime for MiFID investment firms

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 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 2015 and 2019, BVCA members invested over £43bn into nearly 3,230 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private equity and venture capital currently employ 972,000 people in the UK and the majority of the businesses our members invest in are small and medium-sized businesses.

Summary Feedback

We are grateful to the FCA and HMT teams who are working on implementing this mandate for the time they have taken so far to engage constructively with us on the issues arising from this new regime. We look forward to engaging positively in order to support the FCA's stated objective of avoiding an inappropriate or excessive regime that does not align with actual business models or address the risk the firms pose.

We are keen to meet with the FCA to discuss this response. We would also like to discuss our most recent response to CP 20/24. We look forward to engaging with the FCA on these issues as soon as possible.

As described in both our response to DP 20/2 and our response to CP 20/24, the UK Investment Firm Prudential Regime ("**IFPR**") will result in significant changes to the capital, liquidity and remuneration requirements applicable to investment firms currently classified as exempt CAD firms. BVCA member firms could be amongst the most affected by IFPR, despite the negligible level of systemic risks they pose.

We have set out our detailed responses to the questions posed in the Consultation Paper in the Appendix to this paper.

Below we summarise the key issues for our members arising from CP 21/7.

1. REMUNERATION

Application of the rules to PE/VC firms

- Many private equity firms pay a combination of fixed salary and cash bonus. In addition, executives will typically have a carried interest in funds the firm manages or advises. We understand that the proposals on in-year adjustments, malus and clawback would apply to cash bonuses and (as expressly stated in the CP) carried interest.
- We consider firms should be well placed to comply with the rules insofar as they relate to cash bonuses.
- The proposed application of the IFPR remuneration rules to carried interest arrangements will raise a number of practical questions for many of our members.

Carried interest

- Carried interest arrangements are market standard within the global PE/VC industry. Carried interest is an effective and well-established way to align the interests of managers and investors. It has been used for this purpose by the global PE/VC industry for many years, alongside co-investment requirements. To the extent that carried interest arrangements are subject to the IFPR remuneration rules, the FCA should apply those rules in a way that is consistent with current practice in the operation of carried interest schemes, as the FCA has done with the guidance on the AIFM Remuneration Code.
- Carried interest schemes have features that, taken together, meet the intention of the IFPR remuneration rules, including the significant gap between award and cash payout (7 – 10 years is typical) and that "bad leavers" will typically forfeit their unvested carried interest rights (please see our response to Q22 in the Appendix for further details).
- However, carried interest is not part of an individual's remuneration. An individual pays for his or her carried interest and employees will be subject to income tax to the extent they acquire a carried interest without making an appropriate payment for it. The value of carried interest is determined by the performance of the fund in which the carried interest is held, rather than being linked to the performance of an individual holder. Carried interest payments are made only after performance criteria set out in the fund's constitutional documents have been met. This typically requires that a minimum "hurdle" rate of return is delivered. This structure is reflected in a memorandum of understanding (the "**MoU**") agreed between the BVCA and HMRC in 2003 which sets out accepted guiderails within which firms should structure their funds (including carried interest) if their carried interest is to be afforded the traditional tax treatment. That treatment is dependent on recognition of carried interest as a

long-term fixed proprietary interest, which is sensitive to the overall investment performance of the fund but not to individuals' personal performance. It is made very clear in the MoU that an individual's carried interest should not depend on his or her personal performance. Firms should not be required to take any steps which do fundamental damage to long established carried interest structures as reflected in the MoU.

- We are concerned that as drafted, firms will need to spend a material amount of time engaging with the rules to determine whether they are compliant and whether any changes which they may make could interfere with the tax treatment of (sometimes global) carried interest arrangements.

- Many carried interest schemes operate at a global level within a PE/VC group. They are designed by the head office of the PE/VC house, which is often outside the UK. If the UK FCA rules effectively recognise the alignment effect of these schemes, that will be neutral for the UK industry. If, on the other hand, the FCA rules require changes to these schemes, that would act as a disincentive (i) to invest in the UK as a financial services centre, and (ii) for investment professionals to work for UK firms that are subject to these rules, which would create a significant risk of loss of talent for the UK PE/VC industry. This would run completely counter to the government's stated aim of making the UK an attractive jurisdiction for asset managers, which is reflected in developments such as the asset holding company consultation and the wider funds review. We would encourage the FCA to reflect on the (lack of) need for these changes before pressing ahead with requirements which will make the UK a less attractive place to do business and undermine the positive steps being taken by other government departments.

Proposals

- If the MIFIDPRU remuneration rules are to be applied to carried interest, is important that the rules make clear that carried interest is "treated as" remuneration for the purposes of the rules (and not that it "is" remuneration).

- Adjustment should be made to the way in which carried interest is described in the rules to more closely represent the way in which carried interest operates in practice.

- The HMRC MoU contemplates that there should be no link between the value of payment and an individual's personal performance. Firms should not be expected to act counter to this requirement.

- Termination/forfeiture of carried interest has been acknowledged by HMRC as permitted. This would provide firms with some flexibility when applying malus/clawback.

- We would request a meeting with the FCA to discuss this extremely important issue for our members.

Comparison to EU

- The structure of the industry in the UK and Europe means that Luxembourg based staff working for the AIFM would fall outside these rules, whereas UK based staff working for a service provider to the AIFM will be caught. This means global firms may need to adjust their carried interest rules to deal with a UK issue.

2. TRANSITIONAL PROVISIONS

- In our response to CP 20/24, we welcomed the proposed transitional provisions in relation to the own funds requirement for current exempt CAD firms.

- We welcome the comment in paragraph 16.131 of CP 21/7 that the transitional provision relating to FOR for own funds will also apply to the calculation of the basic liquidity requirement. We understand that the effect of this is that the basic liquid assets requirement will be equal to a firm's PMR in the first year and will steadily increase. It would be helpful if the FCA Policy Statement on IFPR could include an updated version of the table from CP 20/24 specifically covering this transitional provision.

- However, we are disappointed that our proposals in our response to CP 20/24 regarding similar explicit transitional provisions in respect of the ICARA have not been included. Without these, the existing transitional provisions are likely to be of extremely limited benefit in helping the affected firms avoid a cliff-edge effect when IFPR comes into effect. It would be helpful if the FCA could expressly note that firms can take the transitional provisions for own funds and the basic liquidity requirement into account in their ICARA.

3. SUPER EQUIVALENCE

- On a number of points in CP 21/7 the FCA has decided to go beyond the requirements set out in the EU version of IFD/IFR. These include applying:

    - IFPR to CPMI firms (we understand a number of EU jurisdictions are not doing this in relation IFD/IFR or are only applying the regulatory capital requirements, or are at least undecided); and

    - the ICARA and basic remuneration requirements to SNI firms.

- We are concerned that, taken together with the other divergences noted in our previous responses to DP 20/2 and CP 20/4, these departures would mean that the UK regime becomes more onerous than the EU regime on which it is based, and would create competitive disadvantages for UK firms against their EU counterparts. This would be a very unwelcome result in the context of Brexit, and one which we are keen to avoid if possible.

4. ICARA – APPLICATION TO SNI FIRMS

- As noted above, we disagree with the FCA's proposed application of the ICARA process to SNI firms on super equivalence grounds. It would be disproportionately burdensome for those firms.

- In addition, the apparent conclusion from CP 21/7 is that SNI firms would in practice need to perform K-factor calculations in order to assess the risks of its business. This is an odd result and is against the stated intention of the rules. It arguably creates a less certain, and therefore more onerous, framework for SNIs.

5. K-AUM

- We welcome the express recognition that the scope of K-AUM excludes: (a) advice to undertakings on capital structure, industrial strategy and related matters, and (b) advice and services relating to mergers and the purchases of undertakings. We consider that many private equity and venture capital firms will be able to conclude that their private equity and venture capital advisory services fall outside of scope of K-AUM.

- We are disappointed that our proposals regarding determining when formal delegation takes place for the purposes of calculating K-AUM have not been picked up following our response to CP 20/24.

- We would again submit that the same approach to delegation should apply both to discretionary portfolio management and to non-discretionary advisory arrangements of an ongoing nature. This would avoid both inconsistent treatment between portfolio managers and advisers, and double counting of the same assets (i.e. by having to include them in the AUM for both the investment manager and the adviser, which goes against the FCA's stated intention particularly in the group context).

6. GROUP CAPITAL TEST

- As noted in our response to CP 20/24, although we welcome the availability of the GCT as an alternative to prudential consolidation and anticipate that many of our members will seek to rely on it, we still have some material concerns regarding the complexity and lack of clarity in its application. The FCA's discretion as to whether to grant permission for the GCT is not clearly defined, which is likely to discourage firms from making applications to use it. In particular, we would welcome further clarification on the criteria for a group to be considered to have a "sufficiently simple structure".

We would be happy to discuss the contents of this letter with you; please contact Tim Lewis at tim.lewis@traverssmith.com and Tom Taylor (ttaylor@bvca.co.uk).

Yours sincerely,

Tim Lewis

Chair, BVCA Regulatory Committee

Appendix: Answers to specific questions

Q1. Do you agree that CPMIs should apply MIFIDPRU requirements to their MiFID business? If not, please provide details of an appropriate prudential regime for the MiFID business of a CPMI.

As set out in our response to CP 20/24, we understand that the FCA's proposed approach to CPMI firms is more onerous than that which is to be applied in a number of EU jurisdictions (including Luxembourg as a notable example) that do not intend to apply IFD/IFR to CPMI firms at all or are only applying the regulatory capital requirements, or are as yet undecided on their approach. This would put UK CPMI firms at a competitive disadvantage against their EU counterparts, which would have the benefit of both the EU passport and lower capital requirements. The FCA may be restricted in the changes it can make to its approach at this stage, but as a minimum the overlap between the IFPR and AIFMD rules should be reduced as far as possible. For instance, CPMI firms should only need to apply the higher of their capital requirements under IFPR or AIFMD, and the ICARA, prudential consolidation and remuneration requirements should be disapplied for such firms.

We also note the FCA's general approach of applying the IFPR rules to a CPMI firm's MiFID business, and applying the AIFMD rules to its AIFM business. However, the proposed application of the remuneration rules, i.e. applying the more onerous of the two regimes to the whole of a firm's business, is inconsistent with this. Firms should be given the choice either to apply the more onerous regime to all of its remuneration, or (where possible) apply each regime separately to its AIFM and MiFID business.

Q5. Do you agree with our proposals on how the value of assets should be calculated, and for when formal delegation takes place, when calculating K-AUM? If not, please explain any alternative suggestions you may have.

1. *Calculation of K-AUM*

We welcome the express recognition that the scope of K-AUM excludes: (a) advice to undertakings on capital structure, industrial strategy and related matters, and (b) advice and services relating to mergers and the purchases of undertakings. We consider that many private equity and venture capital firms will be able to conclude that their private equity and venture capital advisory services fall outside of scope of K-AUM.

We are disappointed that the FCA has not taken into account the concerns we have raised previously on this point. As set out in our response to DP 20/2, the same approach to "delegation" should apply both to discretionary portfolio management and to non-discretionary advisory arrangements of an ongoing nature. This would avoid both inconsistent treatment between portfolio managers and advisers, and double counting of the same assets (i.e. by having to include them in the AUM for both the investment manager and the adviser).

On that basis, where an adviser is providing ongoing investment advice to a portfolio manager in respect of assets managed by that portfolio manager, the adviser should not be required to include those assets in its K-AUM. It is particularly important that this approach is adopted in respect of intra-group advisory arrangements. In those cases, including intra-group investment advice in K-AUM calculations would result in double counting of the same assets within the same group, and may in some cases have the perverse result of requiring the firm providing advice to hold more regulatory capital than the discretionary manager in respect of the same AUM.

We note the FCA's opposing view at paragraph 4.63 of CP 21/7. This appears to be on the basis that advice is a different activity legally from discretionary portfolio management. From a risk to client perspective, there is no basis for drawing this distinction. It means that where manager A delegates management to B, B is not required to hold capital, even though B's actions as discretionary manager bind A and A's underlying clients. This contrasts with the situation where adviser C advises manager A. Here, manager A is not obliged to follow C's advice and yet on the FCA's proposals, C must hold capital, thus duplicating the amount of capital in the regulatory system even though the risks posed by the adviser are lower than those which would be posed by a sub-manager. This cannot be the intended outcome of the rules.

2. SNI thresholds

We would also appreciate clarification from the FCA that the proposed rules for excluding certain delegations from a firm's K-AUM calculations also apply when determining a firm's AUM for the purposes of the SNI firm thresholds.

We do not believe it is appropriate that an SNI firm should effectively lose SNI status because its *UK parent entity* (which is many cases will be unregulated and conducting no relevant activities) cannot meet the (absolute) balance sheet test. This can lead to the UK parent having to apply the rules on a non-SNI basis when the MiFID activities of the group are de minimis (such as a CPMI firm with limited MiFID activities well below the SNI thresholds on a solo basis).

Q6. Do you agree with our proposals for calculating K-COH? Especially for measuring the value of cash trades, and for when certain transactions may be excluded from the measurement of COH? If not, please explain why and provide evidence to support any alternative suggested treatments.

We welcome the FCA's clarification at paragraph 4.77 of CP 21/7 that transactions within Recital 44 of MiFID are outside the scope of K-COH calculations. We note the FCA's comment that this includes venture capital business.

Q10. Do you agree with our proposals for a basic liquid asset requirement, to be met by holding core liquid assets? If not, please explain what alternative proposal you would suggest and why.

The FCA does not appear to have proposed any explicit transitional provisions for current exempt CAD firms in respect of the liquid asset requirement, as we requested in our response to CP20/24, and we would repeat that request here. The liquid asset requirement is new for such firms. As currently drafted, it is likely that this requirement would be higher than the own funds requirement for exempt CAD firms under the transitional provisions, reducing the usefulness of those transitional provisions. Even if the FCA decides to retain the liquidity requirements for exempt CAD firms during the transitional period, those requirements should at least refer to the transitional FOR only.

We note the statement at paragraph 16.131 in CP21/7 that the FCA does intend exempt CAD firms to receive a transitional on the basis that the basic liquid assets requirement is calculated by reference to FOR, and that FOR is subject to a transitional. It would be helpful if the FCA could clarify this position more explicitly when it comes to publish its Policy Statement on IFPR and the final MIFIDPRU rules, in particular by including in the Policy Statement an updated version of the table from CP 20/24 specifically covering this transitional provision.

We also do not think the FCA should go beyond the scope of the EU IFD/IFR and apply the liquid asset requirement to SNI firms, as this would be another instance where the UK would be at a competitive disadvantage in comparison to the EU without any material corresponding benefit.

Q11. Are our expectations of firms regarding the ICARA and meeting the OFAR sufficiently clear? If not, which areas would benefit from further clarification?

1. Transitional provisions

As with the liquid asset requirement, the ICARA will be entirely new for current exempt CAD firms, and the FCA similarly does not appear to have implemented the transitional provisions for such firms that we requested in our response to CP 20/24. For many current exempt CAD firms, the additional own funds requirements that would arise under the new ICARA process (i.e. at least one quarter of fixed overheads) would far outweigh their own funds requirements under the transitional provisions. This would effectively nullify any benefit the relevant firms would otherwise gain from those provisions and would result in a cliff-edge effect. We would again ask that the FCA apply a transitional provision delaying the implementation of the ICARA and the other aspects of IFPR for exempt CAD firms for five years, to allow them time to properly consider their approach to the new rules and subject the ICARA document to the necessary level of internal scrutiny.

2. Application to SNI firms

Also similarly to the liquid asset requirement, the UK should not go beyond the EU IFD/IFR provisions and apply the ICARA to SNI firms. The ICARA process in particular would be disproportionately burdensome for those firms, and we believe it would be largely unnecessary. Our expectation is that the results of the ICARA process for the vast majority of advisor/arrangers would show that these firms pose very little risk to their clients and to the market. Applying this requirement would again put the UK at a competitive disadvantage compared to EU jurisdictions.

In addition, from the FCA's proposals it appears that in practice an SNI firm would need to perform K-factor calculations as part of its determination of the amounts it needs to hold to cover its identified risks under the ICARA process. It is not clear what alternative method an SNI firm could use to assess those risks. This would be a disproportionate and unduly burdensome result for SNI firms, and contrary to the stated intention of the rules.

3. General application

We note the FCA's expectation that firms should take into account potential risks arising from their non-MiFID or unregulated activities as part of their ICARA process. We disagree with this proposal, on the grounds that it would be disproportionate to broaden the scope of the ICARA in this way, particularly where a firm's MiFID activities only form a small minority of its overall activities (including, for example, CPMI firms whose non-MiFID activities are regulated separately).

Our understanding from CP 21/7 is that the OFAR and ICARA requirements should generally be applied at the solo firm rather than group level, and we welcome that proposal, but it would be helpful if the FCA could provide some more clarity on this point.

4. Liquid assets threshold requirement

We note the FCA's rationale behind the basic liquid assets requirement, which requires firms to hold a minimum amount of core liquid assets that will allow them to wind down in an orderly manner. However, we have concerns regarding the additional liquid assets requirement that is being imposed on firms as part of the ICARA process. In practice this would require firms to hold significantly more liquid assets throughout the year, which would be a disproportionate result when taking into account the business models of most UK PE/VC firms.

Q12. Is the rationale for and explanation of the own funds and liquid assets wind-down trigger sufficiently clear? If not, which areas would benefit from further clarification?

As with the ICARA and liquid asset requirements generally, it is not apparent from CP 21/7 that these trigger requirements are subject to the transitional provisions available to current exempt CAD firms in respect of the own funds requirements. If not, the benefits of those transitional provisions are likely to be significantly reduced – see our response to Q11 above.

Q13. Do you agree with our proposal to use an early warning indicator?

Please see our response to Q12 above – the same considerations apply here.

Q17. Do you agree with our proposal for firms to apply the new MIFIDPRU Remuneration Code from the start of their next performance year beginning on or after 1 January 2022?

We agree with this proposal, and welcome the implication in CP 21/7 (and in particular the draft SYSC TP 10.3G) that the IFPR remuneration requirements will not apply to variable remuneration awarded after those requirements come into force, but based on previous performance years. We would request that the FCA further clarify this point when finalising the new rules.

Q18. Do you agree that SNI firms should be subject to the 'basic remuneration requirements'? If not, please explain why not.

We do not agree with this proposal, as it goes beyond the requirements set out in the EU IFD/IFR regime and with no clear justification. As mentioned a number of times above, by going beyond the EU version of the requirements there is a risk that there will no longer be a level playing field for UK and EU firms, and UK firms risk losing talent if UK remuneration regulation is unnecessarily more onerous that EU regulation.

Q19. Do you agree that only certain non-SNI firms should be required to apply the remuneration rules on deferral, pay-out in instruments and discretionary pension benefits? Do you have any comments on the thresholds we propose?

We agree with the FCA's proposals on this point, and do not have any comments on the proposed thresholds.

Q21. Do you agree with our proposals for exempting certain individuals from the rules on deferral, pay-out in instruments and discretionary pension benefits? Do you have any evidence that may assist us in defining the scope of the exemption?

We agree with these proposals.

Q22. Do you have any other comments on the proposed scope and application of the remuneration rules?

1. Carried interest

Carried interest is an effective and well-established way to align the interests of staff and fund investors. It has been used for this purpose by the global PE/VC industry for many years. To the extent that carried interest arrangements are subject to FCA IFPR remuneration rules, the FCA should apply those rules in a way that is consistent with this practice, as the FCA has done with the AIFM Remuneration Code.

Many of these schemes operate at a global level within a PE/VC group. If the UK rules effectively recognise the alignment effect of these schemes, that will be neutral for the UK industry. If, on the other hand, the UK requires specific changes to these schemes impacting only UK firms, that will act as a disincentive (i) to invest in the UK as a financial services centre, and (ii) for investment professionals to work for UK firms that are subject to these rules, which would create a significant risk of loss of talent for the UK PE/VC industry.

It is difficult to make carried interest fit exactly with the IFPR remuneration rules, especially the malus and clawback requirements. In particular, we disagree with the FCA's statement in CP 21/7 that carried interest "is" remuneration. Carried interest is an asset (an interest in a fund) and individuals either pay a proper price for that asset when they acquire it or, if they are employees, are subject to income tax and National Insurance Contributions to the extent they do not. Subsequent increases in value (and in due course distributions) have never been analysed as part of an individual’s remuneration; they are a return on an investment asset. We note that carried interest will nevertheless be "treated as" remuneration for the purposes of the FCA's rules.

To comply with HMRC requirements, carried interest schemes are designed so that distributions are linked solely to the performance of the relevant fund rather than an individual's job performance. Introducing a performance-related element would effectively cause all carried interest schemes to be in breach of the long-standing requirements on this point set out very clearly in the MoU. By requiring a performance-related component to be introduced into carry arrangements the FCA would effectively be directing firms to do something HMRC told them not to do nearly twenty years ago.

In our view, carried interest schemes have features that, taken together, address the concerns behind the IFPR remuneration rules on malus and clawback (i.e. to avoid creating a negative link between the risks taken by staff and the rewards they receive):

- Carried interest is a long-term fixed proprietary interest, and due to the nature of the investments made by PE/VC funds, carried interest schemes generally take many years to produce a return. Carried interest schemes therefore have an in-built element of deferral typically well in excess of the requirement imposed under the IFPR extended remuneration requirements.

- Carried interest schemes typically contain "bad leaver" provisions, which can operate to cancel an individual's distribution entitlements in certain circumstances. Each firm’s carried interest rules will be bespoke to the firm in question but it is common to see such provisions being triggered if a member of staff leaves a firm to go to a competitor or if there are egregious conduct issues, e.g. if the individual commits a serious breach such as fraud, bad faith, serious misconduct or gross negligence.

In our view, taken as a whole the considerations described above combined with the ability to claw back an individual's cash bonus (if applicable) would effectively meet the IFPR requirement to apply malus and clawback to 100% of variable remuneration, even if they do not meet all of the detailed requirements of the rules.

2. Co-investment

We note the draft guidance at SYSC 19G.4.3G(1) that the FCA would treat staff co-investment as remuneration where the co-investment is funded by a loan from the firm. We disagree with this characterisation, and would argue that co-investment fundamentally provides staff with a return on their investment, and is entirely distinct from their remuneration arrangements. In any event, we do not agree that the FCA should go further than the current ESMA AIFMD remuneration guidance on this point, which notes that a co-investment funded by the firm should only be treated as remuneration where the staff member has not reimbursed the loan by the time the return on the co-investment is paid.

Q24. Do you have any comments on the specific remuneration rules we are proposing to apply to all non-SNI firms ('standard remuneration rules')?

Please see our response at Q22 above regarding the application of the rules to carried interest and co-investment.

Q25. Do you agree with our proposal to extend the existing non-Handbook guidance on ex post risk adjustment to FCA investment firms?

No – please see our response at Q22 above regarding the application of the rules to carried interest and co-investment.