Retail Distribution Policy
Strategy & Competition
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

By email: PRIIPsCfI@fca.org.uk

28 September 2018

Dear Sir/Madam,

Re: BVCA response to FCA call for input on initial experiences with the PRIIPs regulation.

The British Private Equity and Venture Capital Association ("BVCA") is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 700 firms, the BVCA represents the vast majority of all UK-based firms, as well as their professional advisers and investors. Over the past five years (2013-2017), BVCA members have invested over £32bn into nearly 2,500 companies based in the UK. Our members currently back around 3,380 companies, employing close to 1.4 million people on a full-time equivalent basis (FTEs) across the world. Of these, around 692,000 FTEs are employed in the UK.

Scope of the PRIIPs Regulation

Q1. Are you experiencing problems with clarifying the scope of the PRIIPs Regulation? Please provide examples of product types where you believe there is uncertainty as to whether they are in scope. Q2: Have you tried to resolve this uncertainty and faced difficulties in doing so? If so, please provide details and examples of the difficulties you have faced.

Private equity and venture capital ("PE/VC") managers primarily market their funds to institutional investors, such as pension funds, sovereign wealth funds, insurance companies, family offices, university endowments and government agencies/development funds. PE/VC funds will typically only have these types of institutional investors and will therefore be wholly outside the scope of the PRIIPs Regulation.

There will be some instances where PE/VC funds structured as limited partnerships are within the scope of the PRIIPs Regulation where prospective investors include high-net worth and/or sophisticated individuals, many of whom will have significant experience of investing in PE/VC funds. For those funds that do engage with such investors, these investors would typically only represent a very small proportion of the fund. These types of investors will not typically meet the MiFID II definition of a professional client (even though they may be eligible under the UK promotions regime) and therefore fall into the category of retail investors for whom a KID is required.

This is unfortunate as these investors will not be "average or typical" retail investors (as described in the European Commission's Explanatory Memorandum dated 3 July 2012). The MiFID elective professional tests are calibrated for MiFID investment services provided in relation to liquid assets such as traded shares. The tests are extremely difficult to satisfy in the case of individuals (regardless of their wealth, sophistication or experience) who invest in long-term PE/VC funds which make relatively few transactions, and who have relevant experience in business (e.g. entrepreneurs) rather than financial services. We have made many representations on the inappropriateness of the MiFID professional client definition over the years and the introduction of the PRIIPs Regulation has potentially limited the number of investment opportunities certain investors had previously.

The requirement to produce KIDs and the administrative burden of opting-up investors has dissuaded some fund managers from marketing to high net worth investors and other categories of investor where otherwise permitted under EEA national private placement regimes. Some of our members have deliberately not offered their funds to certain investors that have invested in previous funds and are experienced and sophisticated investors/industry experts. This is clearly an unintended consequence of the legislation, and we note your reference in the call for input on the impact in the corporate bond market where less access for retail investors limits both the depth and diversity of corporate funding sources.

We think there are potentially two relatively straightforward ways to mitigate this issue without giving rise to investor protection concerns:

- The European Venture Capital Funds (EuVECA) Regulation introduced a class of investors who are now categorised as semi-professional investors. We believe that these types of investors should also be outside of the scope of the PRIIPs Regulation. All prospective investors, including semi-professional investors, are provided with considerable amounts of information on the fund and the fund manager and carry out their own due diligence prior to making an investment. In addition, as part of their investment, they will acknowledge that they understand the risks involved in making that investment. We do not consider that there will be any increase in investor protection should such investors receive a KID.

- As the PRIIPs regulation is targeted at mass-market retail distribution, we consider that a PRIIP should be viewed as "made available" to retail investors within the EEA only where the PRIIP is widely distributed. The requirement to produce a KID should not apply where a fund is distributed on a private placement basis, e.g. where marketing materials are distributed to fewer than 150 retail investors per EEA member state.

We also note that the requirement to publish a KID on the manufacturer's website potentially cuts across the private placement regimes under which PE/VC funds are typically distributed. It is a key feature of private placement regimes both within the EEA and internationally that there should be no general solicitation of investors or general advertising of the product. A PE/VC firm will therefore typically not make any marketing materials relating to its funds generally available on its website. The private placement memorandum and other marketing materials are distributed on a confidential basis to a limited number of investors only. Where a KID is produced to enable the fund to be made available to a limited number of high net worth individuals within the EEA (such as strategic partners in a particular industry sector), the PRIIPs Regulation (Article 5(1) and Article 9) requires the KID to be published on the manufacturer's website. Appropriate disclaimers would be included, but complying with this publication requirement may give the impression that the PE/VC firm is soliciting retail investors generally, even though this is not the case.

In addition to the limited partnership, a smaller number of private equity managers structure their funds as venture capital trusts or investment trusts, structured as a public limited company admitted to trading on a trading venue for which different issues arise (see further below).

Contents of the KID – Characteristics of private equity and venture capital funds

To contextualise and understand our answers to the questions on the contents of the KID, we have set out below the typical features of PE/VC funds.

- PE/VC funds are often, but not always, structured as limited partnerships with a contractually limited life. PE/VC funds have a typical term of ten years with an option to extend, normally by two years.
- PE/VC funds are closed-ended and partnership interests are not intended to be transferred or traded. However, they can be transferred to another investor with the consent of the GP although this does not occur frequently over the term of a fund.
- PE/VC funds invest in unlisted, private companies. These companies are not subject to frequent (e.g. daily) valuations and therefore do not have a readily ascertainable market price.
- PE/VC firms will typically look to hold investments for between three and seven years, at which time they will look to sell, or 'exit', their stake, either on the stock market, to a corporate buyer or to another investor.
- Investments are usually made in the first five years of the fund's term and realised in later years.
- Once the PE/VC firm has invested the majority of the committed capital in the fund, it will go out to market a new closed-ended fund. This could include the same investors as the previous fund and new investors. The investment mandate and the size of the new fund may also be different.

General comments

We have sought to collate feedback from firms that have needed to produce a KID for the closed-ended unlisted fund structure described above. However we have received very limited feedback due to the reasons set out in the scope section above, namely that managers have stopped marketing funds to certain investors that cannot meet the definition of a MiFID professional client. Nevertheless we have provided feedback where possible to demonstrate why the methodology prescribed in the PRIIPs legislation is unsuitable for PE/VC funds.

Some of our members will also produce KIDs for private equity listed investment companies and venture capital trusts. Our feedback on the contents of the KID below does not cover these types of vehicles. We support the responses submitted by the Association of Investment Companies ("AIC") and Listed Private Capital ("LPeC") as these set out the issues our members have encountered with respect to those products. In particular we agree with LPeC's view that listed private equity investment companies should not fall within the scope of the PRIIPs legislation and that the FCA should adopt the approach taken by BaFIN and the AMF to exclude them rather than gold-plate the application of this legislation in the UK.

Where significant, complex pieces of legislation are required these ought to be introduced with as much warning and proper consultation as possible. While we recognise that the FCA does consult prior to the introduction of new legislation, it is impossible to expect all issues and unintended consequences of new rules to be identified during the initial consultation phase as it is only through the practical application of new rules, that all issues are identified.

There should therefore be an opportunity to address genuine unforeseen, as well as previously identified, difficulties otherwise firms end up having to incur significant costs to implement new regulation. The PRIIPs legislation is a very good example of where there needs to be an open discussion on the challenges identified and a commitment to revisit the prescribed methodology with experts that have been producing KIDs over the past year. We recognise there are limits on the changes that can be made from a legislative perspective and so in the interim, the findings of the FCA's call for input should be published as soon as practical. Given the severity of the concerns raised already about the misleading nature of KIDs, there is a justified view that the FCA ought to find a way to suspend the requirement to prepare a KID until all the issues identified can be resolved.

With respect to both the risk and performance scenario calculations, it is not possible to explain the risks in sufficient detail in the KID itself and there is also no space to include additional qualitative information on the assumptions used in the calculations. Therefore firms are having to add footnotes/small print or send accompanying emails/correspondence so that users of the KID are aware of the shortcomings of its contents. This cannot have been the intended result of the legislation.

Contents of the KID – Portfolio transaction costs

Q3: Have any of your calculations of transaction costs under the slippage methodology led to negative, zero or unexpectedly large transaction costs? If so, please provide examples, together with the full calculation of how the output has been obtained, and explaining any assumptions that have been made.

As noted above, PE/VC funds invest in unlisted, private companies and this will be over the investment period in the earlier part of a fund's life. The slippage methodology is therefore not relevant.

The costs and charges related to a fund's investments do not follow a smooth trajectory as the investments will be of different sizes and occur at different intervals. The costs will also be incurred at different levels within an investment holding structure. It is not possible to compare costs on an annual basis and costs will be larger in the earlier years of a fund's life and lower when the fund is fully invested and when the underlying investments are exited. LPeC's response also highlights the issues when comparing costs across different fund and fund-of-fund structures where different types of costs will be captured.

Contents of the KID – Risk disclosure

Q5: Please provide your views, supported by evidence, on the SRI and on the extent to which the required and optional sections of the risk narratives enable the risks of a product to be adequately explained to consumers.
Q6: Do you have any examples of products where the prescribed methodology for assessing and presenting risk leads to a counter-intuitive or potentially misleading SRI? If so, please provide examples.

The specific features of PE/VC funds mean that the risk analysis that is carried out in practice is very different from that of tradeable securities. The PRIIPs legislation was designed for asset classes that have readily available and historical market data and is being artificially applied to PE/VC funds as such data does not exist for private funds.

The methodologies prescribed in the PRIIPs legislation are inappropriate because of the:

- creation of artificial composite benchmarks using, for example, historic AIM listed indices, country or sector/industry indices, to project forward performance scenarios in a PE/VC funds context (creating a simulation would be even more complex, prone to error due to the number of variables and assumptions required, and costly);
- use of complex models to generate risk ratings and performance outputs which would typically be adopted/applied by other types of funds exposed to public market volatility; and
- adoption of time weighted returns, versus internal rate of returns, which are atypical in the PE/VC industry; and
- use of historical data and ex-post methodology to calculate a projected/ex-ante risk indicator.

The use of historical data does account for the stage of an economic cycle and the SRI is likely to be misleading when it is based on data from growth stage of a cycle (as the AIC research has demonstrated). The prescribed methodology does not incorporate any sensitivity analysis that takes into account broader economic risks and sector or product-specific risks.

Please also refer to our feedback in the general comments section above.

Contents of the KID – Performance scenarios

Q7: Have you experienced any practical issues with the calculation and presentation of performance scenarios in the KID? If so, please provide details so that we can identify any further practical difficulties not fully contemplated in our statement of January 2018.

Under the prescribed methodology, past performance is used to project future returns and this fundamentally misleading as does not take into account market and economic conditions. This approach also does not take into consideration the nature of the current underlying portfolio which may differ from previous investment strategies e.g. there may be more investment in one particular sector compared to previous years.

The FCA statement relates to performance scenarios using the prescribed methodologies and does not cover the key characteristics for PE/VC funds which is the recommended holding period and the investment period. The requirement to present data over 1, 5 and 10 years is clearly meaningless given the way the PE/VC investment cycle operates and the fact that there are no (or very limited) redemption rights (see above).

The calculation of performance scenarios is practically difficult for the new PE/VC funds which do not have data on past performance, and accordingly may be relying on sufficient information being publicly available on the current market in respect of funds similar to their own funds, which may not always be the case. The PRIIPs Regulation provides very little practical guidance to this type of PE/VC fund, with the prescribed methodologies appearing more suitable to larger and more established PRIIPs.

Please also refer to our feedback in the general comments section above.

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

Yours faithfully,

Tim Lewis
Chair, BVCA Regulatory Committee