bvca The voice of long-term investment

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Our reference: 12221595

BY EMAIL ONLY

10 March 2011

Dear Mr Ridgwell

CP11/4 The Client Money and Asset Return (CMAR): operational implementation response

The response to this consultation is made by the British Private Equity and Venture Capital Association (the "**BVCA**"). The BVCA represents the overwhelming majority of the UK-based private equity and venture capital firms. We welcome the opportunity to respond to the above consultation paper.

We would very much like to meet with you to discuss the concerns raised in this paper relating to the application of these proposals to private equity and venture capital firms. I would be grateful if you could contact me at Margaret.Chamberlain@traverssmith.com to arrange this meeting.

Q1: Do you agree that we should implement the CMAR for CASS medium and large firms through GABRIEL? If not, please state your reasons why and provide supporting evidence.

We agree that GABRIEL is an appropriate format for the CMAR. However, we are concerned about the appropriateness of the proposed reporting frequency for private equity and venture capital firms which are CASS medium and large firms. Private equity and venture capital firms trade very

infrequently (see below) and we do not consider that the benefit received by frequent reports from such firms is commensurate to the costs of reporting. We have set out below the basis for this view.

Risk

Private equity and venture capital firms invest primarily in unlisted securities, normally on behalf of one or more funds. The funds are typically structured as privately owned limited partnerships. The unlisted securities generally comprise shares and loan notes issued by private companies usually registered in the name of a nominee company which forms part of the private equity or venture capital firm's group. These types of firms are very low risk for a number of practical reasons which we have explained below.

Shares/loan notes issued by a Newco

The company which issues the shares/loan notes held by private equity or venture capital funds is typically a new company ("**newco**") established by the funds' manager specifically for the purposes of the transaction. This newco acquires the target company and the target is wholly owned by the newco. The private equity fund will typically hold 25% or more of the shares in the newco and provide a significant proportion of the financing for the purchase of the newco.

This structure means that the private equity fund has a far higher degree of control over the newco than a fund investing in listed securities typically has over a listed company. If there is an error in the share certificates or loan notes issued by the newco, the private equity fund manager will simply require that the newco issues replacement certificates.

Unlisted Securities

The securities issued by the newco are unlisted and there is no OTC secondary market for them. There is accordingly a significant structural impediment to the possibility of the ownership of the securities being incorrectly recorded in the name of a third party one day, who subsequently trades the securities (resulting in a loss to the fund). Were a third party investor to seek to defraud the fund in this way, the third party who sold the securities would typically be in breach of the shareholders' agreement to which all shareholders are party and the fund would be able to recover any loss from this person.

Infrequent Investments/Divestments

As noted, most private equity and venture capital fund managers will engage in a very small number of purchases or sales of securities each year. Even the medium sized managers will often buy and/or sell only around three to six portfolio companies annually. This contrasts starkly with many managers of quoted investments who typically trade daily.

Due to this low frequency investment activity, private equity and venture capital managers will often carry out a full reconciliation of their portfolio only once per quarter or once every six months. It

would be disproportionately burdensome for such entities to provide the FSA with monthly reports in relation to safe custody issues.

It would be of more relevance to the FSA and more appropriate for the firms to report quarterly or six-monthly. This would also be in line with the approach taken in respect of CASS small firms which are required to report only six-monthly. The revised CASS rules implicitly recognise that CASS small firms present a lower risk. It is appropriate to extend this recognition to private equity and venture capital firms.

We note that if the FSA does go ahead with monthly reporting for private equity and venture capital firms, the CMAR will be the only monthly report they are required to submit to the FSA.

Unreconciled Items

The CMAR requires firms to notify the unreconciled items. If this includes loan notes and share certificates which have not been issued, this will result in significant unreconciled items reporting for private equity firms. This is because loan notes or share certificates are routinely not issued by a newco on a private equity transaction until after the transaction has taken place. There is no risk to the fund in these situations because the private equity manager has complete control over this process (as it is the client of the law firm which is typically responsible for issuing the notes/certificates). It would not confer any investor protection for such firms to report these items to the FSA as unreconciled.

Cost Benefit Analysis

Monthly reporting by firms investing in unlisted securities would affect the cost benefit analysis detailed in FSA Consultation Paper 10/09 **("CP10/09")** and referred to in the current consultation.

The cost benefit analysis in CP10/09 states that there would be an annual cost to firms of between £960 and £8,500 with a one off cost of up to £5,000. Our members expect their costs to be towards the upper level. Given the low frequency with which private equity and venture capital firms perform investments, much of the information supplied in the monthly reports would duplicate information supplied in prior reports. We therefore do not agree that the benefit received by the FSA would be commensurate to the cost.

We support the FSA's reintroduction of the CMAR and encourage measures that offer the FSA greater transparency in regulating firms which hold or control client assets. However the private equity and venture capital industry do not pose the risks to clients which the CMAR is purporting to reduce. It may be more beneficial for the FSA to focus their resources on firms which pose a higher risk in relation to their client assets than private equity and venture capital firms. It may, therefore, be appropriate for firms which invest wholly or predominantly in the shares or debentures of one or more unlisted company to be exempt from the requirement to submit a monthly CMAR.

Q2: Do you agree that minor amendments should be made to the CMAR to implement it through

GABRIEL?

Yes.

Q3: Do you have any comments on the guidance notes or the technical business validation rules?

The guidance for line item 25C contemplates that a line of stock will have a CUSIP or ISIN number. Unlisted securities do not have such numbers. It would be helpful if the FSA could either specify that unlisted securities do not need to be reported in this column or give guidance on what constitutes one line of stock for these entities. Our suggestion (if such entities are to be included) would be that for unlisted securities, any such securities issued by a single group of companies constitute one line of stock. This would mean that where a private equity fund holds shares issued by one company in the group and loan notes issued by the same company or another company in the same group, it can report these to the FSA as one line of stock. For practical purposes, this is how such items are treated by firms.

Q4: Do you agree that the CMAR requirement for CASS small firms be postponed?

Yes.

Q5: Do you agree that we should introduce the CMAR for small firms as soon as it is practicable to do so?

This may be appropriate for small firms managing liquid securities. However the costs of monthly or quarterly CMARs for small private equity and venture capital firms is likely to be disproportionate to the benefits.

Q6: Do you agree that we should introduce a CASS small firm notification requirement to enable the FSA to monitor the CMA of smaller firms before CMAR implementation?

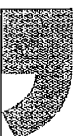
Yes.

Q7: Do you agree that it remains appropriate for CASS small firms to provide the required notification on a half-yearly basis?

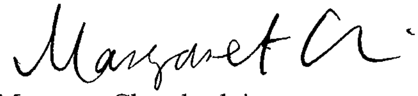
As outlined above, we do not consider that the submission of a CMAR by a private equity and venture capital firm which is a CASS small firm would bring any meaningful benefit for regulatory purposes. However, where such firms are required to submit a report, we agree that this should be on a six-monthly basis.

Q.8: Do you agree with the amended cost-benefit analysis?

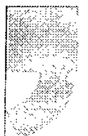
Please refer to our comments on the cost benefit analysis at question 1 above.



Yours sincerely



Margaret Chamberlain
Chair - BVCA Regulatory Committee



The British Private Equity and Venture Capital Association
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Company incorporated in England and Wales