BVCA comment on provisions pertaining to U.S. Investments in Certain National Security Technologies and Products in Countries of Concern

The British Private Equity & Venture Capital Association (BVCA) is the industry body and public policy advocate for the private equity and venture capital (private capital) industry in the UK. With a membership of over 650 firms, we represent the vast majority of all UK-based private capital firms, as well as their professional advisers and investors. In 2022, £27.5bn was invested by private capital into UK businesses in sectors across the UK economy, ranging from consumer products to emerging technology. There are over 12,000 UK companies backed by private capital which currently employ over 2.2 million people in the UK. Over 55% of the businesses backed are outside of London and 90% of the businesses receiving investment are small and medium-sized businesses.

Introduction

We welcome the opportunity to comment on the Advance Notice of Proposed Rulemaking (ANPRM) on the topics related to the implementation of the Executive Order (EO) 14105 "Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern".

The private capital industry understands that national security considerations are a core part of modern-day regulatory environments. There is already close scrutiny of the acquisition of companies in sensitive sectors and much of the focus is understandably on the potential for dual use of technologies or in the development of new areas in deep tech, quantum or AI. These sectors need significant amounts of private capital, and the industry has continued to advocate for clear national security frameworks, allied to consistent and proportionate implementation across the G7 and like-minded jurisdictions. We believe other jurisdictions may look to introduce similar regimes, so it matters that a proportionate, international consensus is quickly established. It is of paramount importance that the impact on cross border investment in high tech sectors is not severely disrupted, and that US persons and capital can continue to work and invest effectively. The BVCA has engaged with the UK government over recent years on various national security regimes and will continue to engage and provide feedback where it is needed.

The impact of the proposed measures will depend on the clarity of the definitions and the final scope of regulations. However, given the already broad scope set out in the EO and ANPRM, private capital firms that are BVCA members with US persons in senior positions and/or US limited partners investing in their funds will need to spend considerable time and resources preparing to comply, adding to the cost and time pressures already apparent in transactions (in part because of the proliferation of national security screening regimes).

We have limited our feedback to areas of the ANPRM that are most important to the private capital industry in the UK. The BVCA would welcome further engagement and we look forward to providing our comments on the draft implementing regulations when they are published.

How the proposed regime would affect our members

Our members are likely to become subject to the new regulations in a variety of ways. One implication is the regulations will raise barriers to entry for North American limited partners who invest significant amounts of capital into our members' funds. Additional uncertainty and risk

as well as extra due diligence requirements could result in less investment into UK funds. This would result in North American savers missing out on the strong returns that the UK industry has a track record of delivering. BVCA research shows the 10-year horizon return of funds managed by our members is 17% p.a.[1] (vs 6.5% p.a. achieved by the FTSE All Share Index).

There is considerable investment by North American limited partners in our members' funds each year. 28.9%[2] of the capital raised by our members in 2022 was from North American limited partners, more than any other region. This equates to £20.3bn. It would be detrimental to the industry in the UK if it were to lose this source of capital due to these regulations and would be equally negative for North American savers to lose out on the returns. The BVCA was pleased to see that limited partner investment may be included as an "excepted transaction" and we would strongly advocate for no de minimis threshold.

A second implication for our members is if a UK private capital firm has US persons working in senior positions, which many do. There are hundreds of thousands of US persons living and working in the UK, and a portion of them work in the private capital industry. They may see their roles become more difficult to execute due to these regulations, and may need to be excluded from some senior management duties. This may have a negative impact on the employability of US persons in senior positions in the UK, which would also be a loss to the UK private capital industry.

Definitions to be developed

We note that a number of key definitions will be developed and finalised during the rulemaking process. The impact of the proposed definitions on the private capital industry in the UK will be dependent on the clarity of these, the guidance produced to assist understanding and how they are interpreted by our members.

- "Knowingly directing transactions"
  The EO includes a definition for "United States Persons", while the ANPRM, published by the US Department of the Treasury (Treasury), states that the prohibitions/notification requirements may apply to US persons globally and potentially to transactions by non-US persons when there is US person involvement. The EO authorises (but does not require) Treasury to include in the implementing regulations a prohibition on US persons "knowingly directing transactions" if the transaction would be prohibited if engaged in by the US person.

  It is therefore possible that a UK private capital firm with US person leadership will be implicated by the regulations, once implemented. We also therefore consider it is possible the implementing regulations may require US persons to either be excluded from a transaction by a UK or other non-US entity and/or, depending on the specific circumstances, certain of the pending notification/prohibition requirements may extend to transactions where a US person is involved, including in a senior leadership position. This will undoubtedly have a major effect on our membership and investment in the UK more broadly, as there is a large cohort of US persons working for our members in the UK.

[1] BVCA-Performance-Measurement-Survey-2022.pdf
[2] Private Capital - Rising to the challenges of turbulent times 2023.pdf (bvca.co.uk)

Treasury notes in the ANPRM that it is contemplating defining "knowingly", for this purpose, as the US person having either actual knowledge or reason to know "*about the conduct, the circumstances, or the result*."

The ANPRM also notes Treasury is considering defining "directing" for this purpose to mean "*that a U.S. person orders, decides, approves, or otherwise causes to be performed a transaction that would be prohibited*" if engaged in by a US person, with a few limited exceptions for secondary services, such as third-party investment advisory services, legal services, and banks processing payments.

It will be very important that the regulations provide clear definitions of what both "knowingly" and "directing" a transaction entail to ensure that the scope of the regime is kept within certain limits.

The proposed definitions of both "knowingly" and "directing" could, as currently drafted, include transactions where a US person is not knowingly directing a transaction but is instead part of standard private capital governance. Two examples of this governance are Limited Partnership Advisory Committees (LPAC) and Investment Committees (IC).

An LPAC typically has an advisory and consultative function, and where it provides this function, the drafting should be made clear that US participants on the LPAC are not "knowingly directing". In addition, there may be limited scenarios where the LPAC has an oversight role. For example where there is some form of conflict involving the fund manager; or the investment falls outside the investment parameters set out in the fund documents, the LPAC may be asked to give consent. In these situations the LPAC is not being asked to advise on the commercial benefits/attractiveness of the deal, but is just approving that the fund manager has appropriately mitigated the conflict/should be allowed to invest outside the typical restrictions. A US person who is a member of an LPAC should not be restricted in their role and should be out of scope of this regime. This should be made clear in the implementing regulations.

In a similar way, a key part of the private capital governance process is done via an IC. An IC is a group of individuals that are responsible for overseeing and managing investments on behalf of a general partner. The committee typically consists of qualified professionals with experience in investment management and financial analysis, who meet periodically to review and approve investment decisions. It takes on a range of roles, including determining the overall investment strategy and policy, setting asset allocation targets, overseeing portfolio performance, monitoring risk levels in investments, and approving individual transactions. The implementing regulations should clearly state what activities of a standard IC would be considered to be "knowingly directing transactions" and clearly carve out activities that are out of scope of this regime.

- <u>Sectors in scope</u>
  The regime will apply to three sensitive technology sectors critical to national security. These sectors are deemed to pose a particularly acute threat to national security due to their abilities to advance military, intelligence, surveillance, or cyber-enabled capabilities.

It is critical that the three key sectors in scope are clearly and narrowly defined to only reflect these acute threats. This aligns with the political aim of the regime and will help give clarity to investors about the due diligence they will need to carry out on individual transactions and throughout their investment supply chains.

In all three sectors it would benefit investors to give clarity on how many "degrees of separation" along the investment supply chain they will be considered liable for the potential involvement of a "covered foreign person".

Paying particular attention to AI, the definition could conceivably cover a huge range of increasingly ubiquitous yet innocuous applications that may be classed as complex (such as software designed to assist in due diligence processes or litigation management) that are likely to pose little or no national security risk. AI is also a fast-moving area of technology with an ever-growing list of links to a range of applications, it is vital that the definition reduces any ambiguity.

US Limited Partner Investors - Potential Exception

The ANPRM contemplates including a category of "excepted transactions" that "due to the nature of the transaction, present a lower likelihood of concern". Currently, Treasury is considering including certain limited partner investments in the definition of "excepted transaction". The criteria being contemplated includes a limited partner investment "into a venture capital fund, private equity fund, fund of funds, or other pooled investment funds, in each case where: (a). the limited partner's contribution is solely capital into a limited partnership structure and the limited partner cannot make managerial decisions, is not responsible for any debts beyond its investment, and does not have the ability (formally or informally) to influence or participate in the fund's or a covered foreign person's decision making or operations; and (b) the investment is below a de minimis threshold to be determined by the Secretary".

The ANPRM states Treasury currently contemplates that any investment that confers certain rights to US persons would not be eligible for the exception. Treasury currently considers that these rights would include, but would not be limited to, board member or observer rights including nomination rights, or any involvement other than voting of shares in substantive decision making, including management or strategy decisions of the target entity.

We agree with the proposal to include limited partner investments into private capital funds as "excepted transactions" and see no reason to include a de minimis threshold as set out in (b) above. Limited partnership laws around the world grant limited liability to limited partners only to the extent that they remain passive investors in a fund, and do not become involved in its management. Investors already have a very powerful legal incentive to ensure that fund documents tightly limit any voting powers that may be conferred (for example via LPAC membership) to high-level strategic and fund governance issues (such as extending the term of the fund). The risk of a limited partner's limited liability status being threatened due to it being deemed to have become involved in the management of a fund, let alone the management of the fund's portfolio companies, is more than sufficient to ensure that fund documents and limited partners' behaviour during a fund's life steer well clear of anything resembling management of

the fund or its portfolio companies. In our view, this existing legal imperative makes a de minimis threshold entirely redundant.

Please do not hesitate to get in touch if you have any questions or if you would like to discuss any of the above in more detail (please contact Tom Taylor (ttaylor@bvca.co.uk) and Ciaran Harris (charris@bvca.co.uk)).