MiFID Coordination
Markets Policy Department
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

By email: cp16-43@fca.org.uk

28 February 2017

Dear Sirs,

BVCA response to CP16/43 - Markets in Financial Instruments Directive II Implementation – Consultation Paper IV

About the BVCA and its members

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 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.

Our member firms are structured in a number of different ways, but fall broadly into the following regulatory categories:

a. Exempt-CAD Adviser/Arranger Firms: These firms typically act as non-discretionary advisors or sub-advisors to fund managers located in other jurisdictions (e.g. the United States or the Channel Islands). Their permissions are limited to: (i) the giving of investment advice; and (ii) arranging transactions/making arrangements with a view to transactions in investments (in MiFID terms, reception and transmission of orders, usually in the wider sense of 'bringing together two or more investors' as described in Recital 20 of MiFID). As MiFID investment firms, these firms are directly affected by the implementation of MiFID II.

b. Full-Scope AIFMs: These firms typically act as the managers of unauthorised collective investment schemes. The funds they manage are most commonly structured as limited partnerships. Some, but not all, of these firms will have the 'top-up' permissions envisaged by Article 6(4) of AIFMD. These firms are affected by the implementation of MiFID II: (i) if and to the extent the FCA decides to extend MiFID II requirements to AIFMs; and (ii) for those firms with top-up permissions, to the extent MiFID II requirements apply to those additional activities.

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c. Sub-Threshold AIFMs and Residual CIS Operators: These smaller firms also typically act as the managers of limited partnership funds. These firms are affected by the implementation of MiFID II if and to the extent the FCA decides to extend MiFID II requirements to AIFMs, and may be disproportionately affected by new requirements owing to their smaller size and more limited resources. A number of these firms are also authorised as exempt-CAD adviser/arranger firms to cover some aspects of their business.

d. IFPRU/BIPRU Firms: A small number of our members are licensed as IFPRU/BIPRU firms. The reasons for this vary from firm to firm. These firms typically carry on a wider range of investment activities and will be substantially affected by the implementation of MiFID II.

Our approach to this response

We have limited our response to those issues that specifically affect private equity and venture capital firms. Given this, we have responded to selected questions only. Many of the issues that affect asset managers more generally will also affect private equity firms to a greater or lesser extent, but those of our members who are affected will typically feed back on these issues either through other industry associations or directly to the FCA.

In relation to those firms licensed as AIFMs, we would reiterate the point made in our earlier letters of 10 November 2016 and 4 January 2017 that any extension of MiFID II requirements to AIFMs will have a material impact, and impose significant extra costs, on these firms. In our view, any such step should be undertaken only to address very clear and specific policy concerns and after appropriate cost-benefit analysis is completed; we do not consider that consistency of approach across firms is, in itself, sufficient justification for any such "gold-plating" of the Directive's requirements. MiFID II contains many requirements which have been designed for firms trading securities admitted to trading on a regulated market or MTF. Private equity firms invest in unlisted companies. Applying MiFID II requirements to these types of firm can give rise to some particular issues because those requirements have not been designed for that type of business.

We also reiterate the challenge made in our letter of 4 January 2017 to the assumption that AIFMs typically perform both MiFID investment management and non-MiFID collective portfolio management, and so a one-size-fits-all approach is easier, more practical or simply expected by firms. For the majority of our investment manager members, their only business is managing private equity or venture capital funds; they do not have a MiFID licence nor otherwise have to comply with MiFID requirements in practice. For these firms, a general levelling-up to MiFID II standards is not a small, incremental change but potentially a requirement to accelerate from a standing start.

Chapter 2: Specialist regimes

Q4: Do you agree with our proposals to update COBS 18 Annex 1? If not, please give reasons why. In particular, are there any issues affecting internally-managed AIFs that we should consider?

As noted in our response letter of 4 January 2017, we do not agree that it is appropriate to mandatorily apply the RPA rules to UK full-scope AIFMs, small authorised UK AIFMs and other CIS operators (together "**Operators**"). AIFMs are already subject to the inducements rules contained in Article 24 of the AIFMD Level 2 regulation. Any change to, or extension of, that regime should be through modification of the AIFMD regime rather than through gold-plating of MiFID II requirements at national level.

Application to private equity

We note that private equity firms do not generally receive "research" relating to unlisted companies in the sense identified in the policy behind the new requirements. However there are a number of areas where the rules could impact the industry, depending on how they are applied.

Due diligence: Carrying out due diligence is a central part of the work of private equity fund managers prior to investment. Due diligence involves private equity fund managers commissioning bespoke reports into a target investment. The reports may be prepared by law firms, accounting/consulting firms and other professional service and advisory firms. The costs of these third parties are generally met by the fund that will ultimately make the investment and these are normally an essential part of the transactional costs on a deal. It is vital that the new research rules are not framed in a way which cuts across that market model (as it would be hugely significant and damaging to the UK private equity market).

Private equity firms may also receive and review vendor due diligence ("VDD") reports on a target investment as part of their due diligence process. Vendor due diligence reports are commissioned by the vendor and are generally paid for by the vendor or target company.

AIFMs are required to conduct due diligence on target investments: this activity is regulated under AIFMD (see e.g. Articles 18 and 19 of the AIFM Regulation (231/2013)).

We are not aware that there has ever been any policy discussion that has suggested that due diligence or vendor due diligence prepared in the course of a private equity transaction should be classified as "research" within the scope of the new research rules.

The RPA requirements of COBS 18 Annex 1 would be very difficult to work if applied to due diligence. For instance the amount of due diligence in any year is unpredictable, as it depends on the number of deals done/their complexity and the cost that is negotiated with providers for their due diligence and advisory work.

Our reading of the amended rules in COBS 18 Annex 1 is that due diligence and vendor due diligence are not related to "execution", but rather to "portfolio management" or "investment advisory" services. Accordingly we consider that due diligence reports are outside the scope of the requirement.

We also note that substantive due diligence is commissioned (or in the case of VDD, received) only after a firm has decided to pursue an investment in a particular company. Accordingly we understand that due diligence does not "inform an investment strategy" in the sense contemplated in the definition of research. The "strategy" (of pursuing a potential investment in the identified target, subject to satisfactory due diligence, negotiation of terms and obtaining finance etc) has already been determined. For this reason we consider due diligence and VDD fall outside the scope of "research".

If we have misunderstood the FCA's intentions in this matter it is imperative we speak at the earliest opportunity to avoid the UK stepping out of line with every other major jurisdiction on this matter. It would be helpful if the FCA could provide specific guidance that these provisions do not apply to due diligence and VDD.

The additional comments made below are based on this understanding of the proposals.

Limited use of "research"

There are some circumstances in which private equity firms may use "research" when executing orders relating to traded financial instruments on behalf of a fund, for example where a fund holds a rump of securities following an exit through IPO. This means a PE firm may trade listed equities less than 5 times a year – in many cases, a firm will not trade listed equities at all in a particular year. We understand that the FCA's intention is to apply the rules to this type of arrangement.

There may be significant advantages to investors if private equity firms are able to receive and use research in these circumstances. There is a risk that imposing RPA-type standards on such firms, where the standards are designed for regular trading, would impose disproportionate administrative costs, given the limited nature of spending in this area for some firms.

We understand that research is "received" when it is sent to a firm. Where a firm accesses publicly available information we understand that this is not considered to be research.

Disclosures to investors

We are concerned that the proposed level of disclosure imposed on AIFMs under COBS 18 Annex 1 4.11R goes beyond that imposed on MiFID firms by requiring a more detailed breakdown of research providers and costs. We would expect that providing aggregated information would be sufficient for investors, in line with the information they will receive from other fund managers.

Governing body

We welcome the recognition in COBS 18 Annex 1 4.4R that where a fund has no independent governing body, then it is not necessary to agree the charge with the fund. The FCA could supply as an additional example the situation of a limited partnership where the firm or its affiliate owns or controls the general partner (which is typically the case for private equity funds structured as limited partnerships).

Yours faithfully,

Tim Lewis
Chair, BVCA Regulatory Committee