James Ferris
Financial Reporting Council
8th Floor, 125 London Wall
Barbican
London EC2Y 5AS

By email: AAT@frc.org.uk

31 October 2023

Dear James

Re: Revisions to the FRC's Ethical Standard: Invitation to comment and impact assessment

The 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 around 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.

The BVCA has always been supportive of, and involved in, government initiatives on corporate governance reform, corporate reporting and the consideration of different stakeholders (including employees and pensioners), and work by the FRC on the Ethical Standard (i.e. the provision of non-audit services). Through our work on the Wates Principles for corporate governance and the Walker Guidelines on transparency, large UK private equity-backed companies currently provide significant levels of disclosure. Indeed, in many of these areas, private equity-backed companies are leaders, with a sharp focus on effective governance and responsible stewardship. Companies covered by the Walker Guidelines already comply with some of the requirements currently applicable to Public Interest Entities (PIEs).

The BVCA understands and agrees with the argument for removing the Other Entities of Public Interest (OEPIs) definition. Understanding which entities fell within its scope proved challenging since its introduction in 2019, particularly when cross referenced to other legislation. Additionally, the BVCA understands the context for the FRC's recently issued Call for Evidence on Non-Financial Reporting in the UK and more significantly, the Government's intention to expand the PIE definition. Officials and the FRC will want as much consistency as possible with thresholds across financial and non-financial reporting.

However, we are concerned that if both proposals are brought forward, there could be a detrimental effect on the provision of audit and non audit services for our members and their portfolio companies unless steps are taken to address this. The expansion of the PIE definition will bring into scope many large portfolio companies, who may have several different audit firms providing services; while the removal of the OEPI category of entities in the Ethical Standard will remove the adaptation we sought and agreed in 2019-20. This will lead to complexity, choice and cost issues for the private capital industry and will result in significant market disruption. When the government and the FRC implement these changes, it is vital that the adaptation from 2019-20 (made to address our concerns on choice of auditors) is carried forward into new regulation/legislation.

BVCA Position

The BVCA has always supported measures to improve quality and independence in the audit market. The reason we sought an adaptation to the FRC's initial proposals was to accommodate the fund structures used in our industry so as to not to limit choice for private capital firms. In 2019 and early 2020, the BVCA engaged with the FRC on its revised Ethical Standard which limits the provision of non audit services by audit firms to their audit clients that are classified as PIEs or OEPIs. The standard became effective for PIEs for accounting periods commencing on or after 15 March 2020, and for OEPIs for periods commencing on or after 15 December 2020.

The existing implementation guidance for private equity or venture capital funds was included by the FRC in November 2020. It is important to emphasise that the guidance does not seek to limit the application of Ethical Standard paragraph 5.40 to services provided to the UK parent and the OEPI itself. It does, however, allow the OEPI auditor to provide other services to the UK parent in respect of its other portfolio companies or non OEPI investments. If the changes proposed result in PE implementation guidance ceasing to exist, then the unintended consequences on the rest of the funds/portfolio companies becomes a major concern for the private capital industry. We set out our assessment of the impact below and suggest some recommended steps to address this.

The structure of private capital funds, and the way in which firms invest in and manage businesses, is very different to a typical corporate group. However, the Ethical Standard still applies because private capital funds will typically have controlling stakes in the portfolio companies in which they invest. Portfolio companies are acquired and sold by the fund more frequently than in a corporate group which adds to the complexity of managing independence conflicts as many audit firms will be used. In turn this means that there can be unintended consequences such as delays to a transaction timetable to address independence requirements, even where the threats to auditor independence are limited or non-existent. Private capital firms can therefore be at a disadvantage to corporate groups in a M&A process as it is more difficult for them to impose a change of audit firm or prevent a portfolio company from using an audit firm.

We are therefore concerned about the potential adverse impact of the proposed changes and are of the view that the private equity (PE) implementation guidance needs to be maintained, either in the revised Ethical Standard or introduced into primary legislation and we set out below out reasons for this. We set out our assessment of the impact below and suggest some recommended steps to address this.

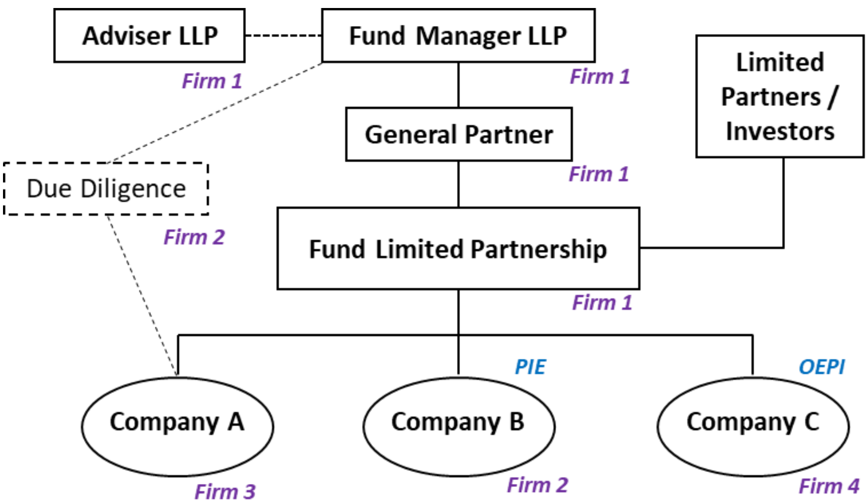
Structure of a private capital fund and its portfolio companies

Private capital firms typically use a limited partnership to structure funds and an example of a structure is set out below.

- The general partner of the limited partnership fund will delegate its power and authority to the private capital manager (often limited liability partnerships with the partners being the executives).
- Private capital firms will manage one or more funds. The funds are closed-ended meaning that they have a limited life span, the industry standard being 10 years. The life span of a fund can be extended (if permitted in the fund's constitutional agreement) and this is typically up to two additional years.
- Private capital firms raise capital to invest from sources such as pension funds, endowments, insurance companies, banks, family offices/high net worth individuals and sovereign wealth

funds. These overwhelmingly institutional and well-informed investors will be limited partners in the fund and their liability is limited to the capital provided to the fund.
- The fund will typically invest in 10-15 companies ("portfolio companies") in the earlier part of a fund's life until an agreed date (e.g. 5 to 6 years) and exit investments in the run up to the fund's tenth anniversary. Typically, firms will sell their stake in a company by listing on the public markets or, more frequently, selling to a strategic buyer. The typical number of companies in a fund would be ten to fifteen.
- The fund's ownership percentage in the portfolio companies will vary depending on the private capital strategy (e.g. buyout, minority stake).
- Private capital acquisitions will often be partly financed by debt, often provided by a number of banks.
- The portfolio companies will operate independently of each other.

In contrast to a corporate group which, more often than not, will use one firm for the audit of all its group companies, private capital structures (i.e. the manager, fund(s) and its portfolio companies) do not operate in the same way. This is described above and illustrated in the diagram below. In particular, many private capital firms do not see it as their role to intervene in portfolio company management's decision as to which firm is engaged as auditors. Hence, it will often be the case that many different firms audit different portfolio companies. The diagram below illustrates the complexity of the situation and the potential for there being multiple audit firms involved across a typical PE fund.



Practical impact of both changes

The expansion of the PIE definition and revision of the Ethical Standard will have a detrimental effect on choice in the audit and non audit services market. The expansion of the PIE definition will bring into scope many large portfolio companies, who may have several different audit firms providing services while the removal of the OEPI category of entities in the Ethical Standard will remove the adaptation we sought in 2019/2020. This will lead to complexity, choice and cost issues for the private capital industry and will result in significant market disruption.

It is important to retain the PE implementation guidance because it will ensure the Ethical Standard is applied fully to the fund in relation to any PIE portfolio companies that it holds and their auditor. The fund would still be able to engage that audit firm to provide services in respect of any portfolio companies within the fund where the service is not relevant to, or in respect of the audited PIE portfolio company. Otherwise, the portfolio companies and the private capital firms will potentially be restricted in using any of these audit firms for services that it itself is looking to procure (even for the provision of services in relation to an unrelated portfolio company which itself is not a PIE). This restriction on choice is a significant issue as it conflicts with another fundamental point for a private capital firm, being their obligation (both contractually under the fund documentation and as a fiduciary acting in the best interests of its investors) to seek support and advice from the most relevant and appropriately experienced advisors. This advice includes due diligence and structuring services. The adaptation ensured that the new restrictions on auditors did not taint the entities in a fund structure, including other (non-related) portfolio companies, and the fund manager.

BVCA key recommendations

We are of the view that the PE implementation guidance needs to be maintained, either in the revised Ethical Standard or introduced into primary legislation.

There are already clear rules regarding the provision of non audit services to PIEs. The planned expansion of the PIE definition means that the impact on the PE fund market is potentially extensive, as large private companies (which could be controlled by a private capital fund) come into scope of the PIE definition. Historically with the exception of some bank and insurance company investments, PE funds did not typically control listed companies or PIEs.

When the OEPI definition was introduced, it was agreed that the PE implementation guidance was needed to seek to limit any damage to the operation of UK Plc, preserve choice in the market and limit disruption to portfolio companies. We believe the PE guidance has worked effectively and has not been abused, hence why we think it is important to maintain the PE guidance in the event that the OEPI definition is removed and to apply it to the new PIE definition. We have some high level suggestions but appreciate this is a complex area:

<u>Primary Legislation regarding PIE definition</u>

The question of maintaining the PE implementation guidance in the event of the removal of the OEPI definition, may be best delayed and addressed at the point that the government publishes primary legislation to expand the PIE definition. There would be some merit in taking the opportunity to engage with the government with regard to the importance of the PE implementation guidance, such that it can be introduced into primary legislation. This would allow alignment between the FRC Ethical Standard and primary legislation relating to PIEs.

We would be happy to participate in any government discussions on this topic, recognising that there is also a need to maintain consistency with IESBA definitions and this may limit the changes that could be implemented.

<u>Ethical Standard</u>

This letter explains why the PE implementation guidance that is currently included in the November 2020 document needs to be preserved, after removal of the OEPI definition. It needs to be included in guidance relating to the new PIE definition and its interpretation. The BVCA appreciates that this is a complex area and there is a balance to be met between legislative change and regulatory interpretation of that legislation.

In the event that primary legislation cannot be changed to incorporate the PE guidance into the definition of a PIE and its UK parent, it would be important to ensure that regulation reflects the specificities of a typical private capital structures and does not treat it the same way as a conglomerate or large corporate group.

The BVCA therefore requests that the FRC explore ways to introduce a set of principles that apply in PE house fund situations within the Ethical Standard (essentially re-instating the PE implementation guidance for the new PIE definition, once the OEPI definition is removed). This might include a consideration of:

- how the rules in para 5.40 apply to situations where a UK parent fund seeks advice in relation to unconnected portfolio companies. Is there a way to limit the application of the para 5.40 restrictions in PE situations, such that the services to a UK parent are prohibited where they are in respect of the PIE portfolio company but explain how the rules apply to situations where the UK parent seeks advice in relation to an unconnected portfolio company.
- Could 5.40 be amended such that a fund is not a "UK parent" as it does not exert the same level of management influence as a corporate group situation. By introducing the PE implementation guidance in this section, this will mean that choice for unconnected portfolio companies in the same fund would not be restricted (subject to threats and safeguards), but services in connection with the PIE portfolio company would have to comply with ES.

How this will impact private capital

If both of these changes are implemented, and our members and their portfolio companies are restricted in their choice of non-audit services (for example, with due diligence), firms will be required to either:

- choose unsuitable advisors, which would lead to sub-standard investment decisions and contradicts regulatory obligations as well as fiduciary responsibilities to investors to act in their best interests; or,
- withdraw from M&A processes, which will reduce competition for sellers. This would have a bad outcome for entrepreneurs and founders.

A more likely outcome is that firms would choose a ‘house’ auditor, most likely outside the Big 6 accounting firms, and force all portfolio companies to change to that auditor on acquisition. This would be negative outcome because:

- Private capital funds do not typically dominate the decision making and governance in place at a portfolio company – a private capital fund imposing its “house” auditor on a portfolio company goes against the typical advisory nature of the relationship between them.
- M&A processes would be stalled or interrupted to allow auditor changes, dampening liquidity in the M&A market.
- CFOs and finance teams of portfolio companies would be distracted by such transitions, distracting management time away from portfolio growth, as well as incurring unnecessary cost
- Audit firms would lose efficiencies gained by building knowledge about their clients.
- You could have some very large businesses (and potentially PIEs) audited by non-big 6 firms which in certain situations might increase audit risk.

In summary, private capital firms will either forgo non-audit service provision by one or more accounting firms if they provide audit services to the firm or any of its portfolio companies, or will frequently have to change auditors of the various entities within its structure. This is neither in the interests of the investors (including pension funds, family offices and foundations) of the private capital funds, nor is there a broader public interest in doing so.

We would welcome further discussion with the FRC and Government on this important matter. Please do not hesitate to get in touch (please contact Ciaran Harris at charris@bvca.co.uk).

Yours sincerely,

Jonathan Martin

Chair, BVCA Accounting, Reporting & Governance Committee