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

August 2024

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 appreciate the opportunity to comment on the proposed rule related to Executive Order 14105 of August 9, 2023, "Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern". The UK private capital industry recognizes the importance of national security in regulatory environments. There is already significant scrutiny of acquisitions in sensitive sectors, particularly those involving dual-use technologies. These sectors require substantial private capital, and we advocate for clear, consistent, and proportionate national security frameworks across the G7 and like-minded jurisdictions so that cross-border investments in high-tech sectors are not severely disrupted and that US persons and capital can continue to operate effectively. The BVCA has actively engaged with the UK government on national security regimes and will continue to provide feedback to decision makers.

As we previously noted, the impact of the proposed measures will depend on the clarity and scope of the final regulations. Given the broad scope of the proposed rule we reiterate that BVCA members with US persons in senior positions or US limited partners (LPs) will need to allocate significant resources to comply, adding to existing transaction demands. Accordingly, we have focused our feedback on the most critical areas for the private capital industry in the UK.

How the proposed regime would affect our members

We continue to have concerns that our members are likely to be impacted by the new regulations in two significant ways. *First*, the regulations would create unnecessary barriers for limited partners from the United States, who invest heavily in our members' funds. Increased uncertainty, risk, and due diligence requirements may reduce investment into UK funds. This would deprive US savers and investors of the strong returns the UK industry delivers (15%[1] p.a. over 10 years vs. vs 5.3% p.a. and 7.5% p.a. achieved by the FTSE All Share index and the MSCI Europe index). In 2023, 29.5%[2] (£17.6bn) of the capital raised by our members came from North American limited partners. Losing this capital

[1] BVCA-Performance-Measurement-Survey-2023.pdf

[2] BVCA-Report-on-Investment-Activity-2023.pdf

source would harm both the UK industry and US savers. We advocate for limited partner investment to be classified as an "excepted transaction" with no de minimis threshold.

Second, these regulations would cause difficulties for the many UK private capital firms employing US persons in senior roles. These regulations could complicate their positions, potentially excluding them from certain duties and negatively affecting their employability in senior and managerial roles. This would be a loss for the UK private capital industry, which benefits from their expertise.

<u>Responses to definitions in the proposed rule</u>

We were pleased to see the three key sectors clearly and narrowly defined, as well as the clarity provided on the due diligence requirements, specifically regarding the extent of liability along the investment supply chain for the involvement of a "covered foreign person". Regarding the AI sector, we appreciate the Treasury's efforts to limit the scope to US investments in entities developing AI systems with applications that pose, or could pose, significant national security risks. However, we still request further clarity on key definitions, particularly:

- <u>"Knowingly directing" an otherwise prohibited transaction</u>

  The Treasury notes in the proposed rule that it is contemplating defining "knowingly directing" an otherwise prohibited transaction as follows: "A U.S. person is prohibited from knowingly directing a transaction by a non-U.S. person that the U.S. person knows at the time of the transaction would be a prohibited transaction if engaged in by a U.S. person. For purposes of this section, a U.S. person 'knowingly directs' a transaction when the U.S. person has authority, individually or as part of a group, to make or substantially participate in decisions on behalf of a non-U.S. person, and exercises that authority to direct, order, decide upon, or approve a transaction. Such authority exists when a U.S. person is an officer, director, or senior advisor, or otherwise possesses senior-level authority at a non-U.S. person."

  Based on the proposed rule, we understand that the implementing regulations may require US persons to be excluded from transactions by UK or other non-US entities. Depending on the circumstances, certain notification or prohibition requirements may also extend to transactions involving US persons in senior leadership positions. This will significantly impact our membership and investment in the UK, as many US persons work for our members in the UK.

  Additionally, the proposed definition of "knowingly directing" could include transactions where a US person is not actively directing but is part of standard private capital governance, such as Limited Partnership Advisory Committees (LPAC) and Investment Committees (IC).

  As we have previously explained, an LPAC typically has an advisory and consultative function, and the final rule should make 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.

Similarly, an IC oversees and manages 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.

US Limited Partner Investors - Potential Exception

The proposed rule includes a category of "excepted transactions" that are considered to present a lower likelihood of concern. Currently, the Treasury is considering including certain limited partner investments in this category. The Department of the Treasury seeks comments on two alternatives for this exception. *First*, under Alternative 1, a US person's investment as a limited partner in a pooled investment fund would be an excepted transaction if (1) the LP's rights are consistent with a passive investment, and (2) the LP's committed capital is not more than 50% of the total assets under management of the pooled fund. If the LP's committed capital exceeds 50%, the investment would still qualify as an excepted transaction only if the US person secures a binding agreement that the pooled fund will not use its capital for a prohibited transaction. *Second*, for Alternative 2, a US person's LP investment in a pooled fund that invests in a covered foreign person would be an excepted transaction only if the committed capital is not more than $1,000,000.

We support the proposal to include limited partner investments in private capital funds as "excepted transactions" and see no need for *either* of the de minimis thresholds mentioned above. If, however, the Treasury were to require a de minimis threshold, we view Alternative 1 as the superior option because it would capture fewer transactions. Limited partnership laws globally grant limited liability to LPs as long as they remain passive investors and do not engage in management. As a result, investors already have strong legal incentives to ensure fund documents limit any voting powers (e.g., via LPAC membership) to high-level strategic and governance issues, such as extending the fund's term.

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).