The voice of long-term investment

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By Email: financial.reform@hmtreasury.gsi.gov.uk

Dear Sirs,

Re: BVCA Regulatory Committee response to Her Majesty's Treasury Consultation: the blueprint for reform (CM8083)

This response to HMT's consultation on a new approach to financial regulation: a blueprint for reform is made by the British Private Equity and Venture Capital Association ("BVCA"). The BVCA represents the overwhelming majority of UK-based private equity and venture capital firms.

Most BVCA full member firms act as investment managers and/or investment advisers and are authorised by the Financial Services Authority. They will, in common with all other authorised firms, be affected by the proposals for reform. It is our expectation that all of our member firms will be regulated by the FCA.

We are restricting our comments on the legislation to two areas which we believe are important. The first because we believe that it has implications, which have not yet been considered, for the position of investment managers. The second because we believe it has a potentially damaging implication for the perception of the UK as a place for a European private equity firm to have its head office. We are deeply conscious of this issue at present because of the forthcoming Alternative Investment Fund Managers Directive ("AIFMD"), which we know is causing many firms to consider both their own locations and the locations of their funds etc. Some European jurisdictions (in particular Luxembourg) are actively promoting themselves as the place for AIFMD managers to be based. We are keen to ensure therefore that there are no other issues, outside of the AIFMD, which could influence firms to move their centre of operations from the U.K., if this can be avoided.

Unregulated holding companies

The White Paper now contains some detail about the proposed power for the PRA and the FCA to impose requirements on certain parent undertakings of UK authorised firms. Our understanding of the provision is that this power may be exercised in relation to certain parent undertakings of any authorised person which is a body corporate incorporated in the UK which is either:

- authorised by the PRA; or
- an investment firm.

In practical terms the power relates to the vast majority of authorised firms including investment advisers, investment managers and brokers.

The power to give directions may be exercised only over a parent undertaking which is a body corporate incorporated in the United Kingdom which is not itself authorised.

Whilst it appears to be a condition that the parent undertaking is a 'financial institution' of a kind prescribed by the Treasury by order, we note that:

- the Treasury has power to omit the word "financial institution", so that the power could be applied to any UK corporate; and
- there are no indications as to the type of institution that may be prescribed by the Treasury as a 'financial institution'.

We note the provisions of S.192B(6) of the legislation which require the regulator to "have regard to" the desirability and practicability of using the power. However, this is not a sufficiently high threshold to prevent this power becoming used as a standard regulatory tool. In addition, the terms of Condition D at Section 192B offer little comfort as this permits the use of the power when a regulator considers that the acts of a parent are having or *may have* an effect on the regulation of an authorised person – there is no requirement for the acts of a parent to in fact have had an effect or indeed for the regulator to have reasonably formed its opinion.

In short the legislation creates a wide ranging power to give directions to unauthorised entities. We note that it is also a power that can have retrospective effect since it can require the parent undertaking to review or take remedial action in respect of past conduct. The phrase "remedial action" is to our mind extremely strange in this context, as it implies that there has been a failing. Yet our understanding is that this power can be exercised where there has no been no failure of any kind by the parent undertaking to comply with applicable law, and by definition it is not subject to any regulation. It may therefore be required to "remedy" something for which it would have had no idea, at the relevant time, that its "act or omission" could be of the kind which it might subsequently be required to "remedy". There is a Kafkaesque quality to a power which permits the retrospective penalty of actions which, at the time of their performance, were done in accordance with existing legislation.

The uncertainty created by the proposed power is significant. The lack of certainty about the use of the power makes it impossible to know how to plan or indeed what to say to investors. It is relevant for BVCA member firms, for two reasons. The first is that some of them invest their funds under management in FSA authorised firms. The second is that the firm may itself be part of a group with a corporate parent, including where the corporate parent is itself a listed company.

The White Paper now gives examples of how the power might be used, and we note that this includes directing the parent undertaking to provide additional capital or liquidity to the authorised firm. We consider that the regulators have adequate power over authorised firms to impose own initiative variations of permission which effectively restrict the authorised firm as to the way in which it may carry on business and enables the regulators to place other requirements and limitations on a firm's ability to carry on business. We see no need for this additional power, and we see significant dangers where this power is used to force a fiduciary to take decisions which are not in the interests of its own investor clients.

In a structure established by an investor (whether or not a private equity firm) to invest in an authorised firm, there will almost inevitably be one or more holding companies between the investing fund and the authorised firm. These companies may (but need not) be incorporated in the U.K. The effect of the power as drafted could in substance be to force an investment manager, which has fiduciary and regulatory duties to the investors whose money it manages, to put further investment into an authorised firm, where it would not otherwise, in the exercise of its discretion, choose to do so. Apart from the fact that it is not clear that such a power of direction to a fund manager would enable the fund manager to act consistently with its other regulatory duties (including those which will be applied to it under the Alternative Investment Fund Managers Directive) we believe the proposal to be unnecessary in this context for the reasons given above.

We also note in passing that it creates yet another perverse incentive to establish investment structures through non-UK entities (such as Luxembourg companies, a structure commonly used), which itself has the related effect of gradually shifting the centre of focus away from the UK.

If the power is to exist then it should be directed at those situations where the capital position of the authorised firm could have a direct negative impact on consumers. We therefore draw a distinction between banks and insurance companies and other firms. Consumers are directly exposed to banks and insurance companies because their rights (to a return of their deposit or to the payment out on an insurance policy) are only contractual rights against the institution, and their fulfilment depends upon the institution's solvency. We contrast this with the situation where a customer's assets are held in custody, in which case he is protected on an insolvency of the firm, because his claim is against the assets held in trust, and not directly against the firm.

In short we therefore consider that the power is not required, given the range of powers that can be used against authorised firms and that, if it is retained, it needs substantial amendment to ensure that:

- it cannot be used to force an investment manager or investment adviser to act against the interests of their clients; and
- it can only be used in respect of parent undertakings of banks and insurance companies.

Revisions to enforcement powers

We note with concern the move towards the publication of warning notices. Whilst to date we are not aware of any enforcement action against a BVCA member, and we hope that this will continue to be the case, the philosophical shift concerns us because it could have serious and unjustifiable impacts on the ability of a firm to continue in business or an individual to retain or obtain employment. We do not believe that the public (or indeed investors) would appreciate the difference between a Warning Notice and a Final Notice and we are aware that Final Notices can and do differ significantly from those contained in the preceding Warning Notice. The Warning Notice is issued at a time when there has been no "independent" assessment of the evidence, nor has the firm or individual had any access to material held by the regulator, which may in fact assist it in its case. We also understand that proceedings may be discontinued after the Warning Notice stage.

If a private equity firm were issued with a public Warning Notice during a fund raising period this would amount to a de facto public censure at a very early stage in the investigation and enforcement proceedings. It would have the potential to be extremely damaging to the firm and would tarnish its reputation in the eyes of potential investors, and we do not believe that this would be mitigated by the Warning Notice either subsequently being withdrawn or a Decision Notice being substantially different. Under this proposal investors would see potentially groundless allegations made against the firm, at a time when the firm has had no opportunity for a proper 'independent' analysis of the case. Nor does the legislation permit the firm to explain its position to investors. It has to sit and watch its reputation being potentially destroyed by allegations which it may believe are not properly based. A Warning Notice is not always followed by a Decision Notice and we know that even when they are they are often fundamentally different.

Our concern is not that investors should not know of the regulatory concern, a firm could not close a fund if there were an outstanding regulatory investigation that had not been properly disclosed or completed as it would inevitably be in breach of its obligations to investors. But we cannot agree that it is right that the regulator should be able to make public statements, which could be extremely damaging and ultimately withdrawn, particularly where the firm is prohibited from itself making any comment. We do not see how this power assists firms in mitigating their "franchise risk", a question often raised with firms by the FSA, and it is another example (by analogy) of 'gold plating', as we are not aware of any other European regulator that pursues such a policy. We therefore urge the Government to think again, as we do not believe the arguments advanced for this new power are cogent, and in any event we believe the potential impact of the use of the power is disproportionate to any benefit that could be gained from it. If the FSA were so concerned about any particular firm at a particular point, it could always issue an own initiative variation of permission. We therefore see no reason to interfere with the fair process provided for by the Financial Services and Markets Act 2000.

Yours sincerely

M. Ch

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Chair - BVCA Regulatory Committee

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