BVCA response to FSA Consultation CP12/19

This response is submitted on behalf of the British Private Equity and Venture Capital Association ("BVCA").

The BVCA is the industry body and public body advocate for the private equity and venture capital industry in the UK. More than 500 firms make up the BVCA members, including over 250 private equity, mid-market, venture capital firms and angel investors, together with over 250 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

The BVCA is responding to this consultation principally on behalf of our VCT and EIS fund members though it should be said that responses to our own member engagement on this has not been limited to these categories. This is not least because the proposals could make it more difficult for private equity fund managers to be issued shares in companies in a PE NewCo structure, this is inconsistent with the Alternative Investment Fund Manager's Directive (AIFMD) which positively encourages such alignment of interests between investors and fund managers. Fundamentally we believe that it is fundamentally inappropriate to include venture capital trusts and enterprise investment schemes within the scope of the consultation

The aim of CP12/19 is to propose changes to the FSA rules, under which the promotion of UCIS "and close substitutes" would be banned to ordinary retail investors in the UK. The key reason for that is that these products are "exposing ordinary investors to significant potential for detriment" [para 1.1]. Para 1.2 in summarising the proposals, also refers to clarifying handbook guidance on financial promotions and improved record keeping of financial proposals.

We consider that the FSA's proposals to restrict the types of investors to whom unregulated collective investment schemes ("UCIS") and, more importantly, 'close substitutes' of UCIS ("Close Substitutes") (together, non-mainstream pooled investments ("NMPIs")) may be promoted are fundamentally flawed and could cause serious detriment to the UK's private equity ("PE") and venture capital ("VC") industries.

Our key concern is that the drafting of the rules renders them far wider in scope than appears to have been intended or is justified. Reliance on the FSA Glossary definition of "special purpose vehicle" ("SPV") in the definition of "NMPI" means that a number of legitimate retail investment structures, including venture capital trusts ("VCTs"), non-UK investment trusts and

British Private Equity & Venture Capital Association
1st Floor North, Brettenham House, Lancaster Place, London WC2E 7EN
T +44 (0)20 7420 1800 F +44 (0)20 7420 1801 bvca@bvca.co.uk www.bvca.co.uk

investment opportunities in holding companies incorporated for use in PE/VC structures ("PE/VC NewCos"), are potentially caught.

Furthermore, while the Consultation Paper envisages a ban on the promotion of NMPIs only to "ordinary" retail investors, there will, in effect, be a ban on promoting certain Close Substitutes (including VCTs) to all retail investors, including high net worth and sophisticated retail investors, due to the narrow scope of existing exemptions in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "FPO").

We further consider that the proposals arbitrarily differentiate between investment products which expose consumers to similar risks. The differential treatment of, for instance, investment trusts, non-UK investment trusts and VCTs is one such example. Furthermore, there is no evidence set out in the Consultation Paper as to retail investor detriment in the context of investments in VCTs, non-UK investment trusts or PE/VC NewCos. Indeed, as these types of investment do not display many of the characteristics said to be typical of NMPIs, it is inappropriate to equate them with UCIS. In particular, VCTs are listed vehicles subject to stringent financial, governance and regulatory requirements and standards. Not only does this make it inappropriate to equate VCTs with UCIS but also creates an unlevel playing field between VCTs and other listed companies.

In today's context, all those who participate in financial services, whether buyers, sellers, intermediaries or regulators, are tasked with restoring trust in this industry after a crisis which has seen in myriad ways, significant consumer detriment. It is important to note that the BVCA supports the provision of properly regulated advice and it is clear from the egregious examples given in the consultation, this is not always what customers have received – we should do everything we can to prevent a repeat. Recent press releases from the FSA[1]point to very poor advice where products are offered which are a very poor fit for the needs of the consumer.

This consultation seeks to address these examples through a mixture of improving the regulation of financial advice provision and banning the marketing of products to certain categories of investor.

[1] http://www.fsa.gov.uk/library/communication/pr/2012/099.shtml

We would strongly urge the FSA to focus on advice and do so using evidence drawn from our experience managing particular products, namely investments in EIS and VCTs. By way of note, a number of our members manage quoted investment trusts which in turn invest in unquoted private equity and venture capital opportunities – these include 3i (market cap £2 billion), Electra (market cap £630 million), and Northern Investors (market cap £43 million). There is no indication that these are covered by the consultation though, other than the income tax break (which is intended as a risk mitigant), there is little difference in the substance of their investment policies to those of VCTs.

We believe the starting point should be an approach that focusses on embedding the Retail Distribution Review (RDR), which will prevent products from being offered inappropriately, because of either poor quality advice or commission bias. Indeed the approach set out by the FSA in the consultation makes many of these points.

It is clear from the examples given, that some of the products mentioned could only have been offered either because the advisors in question were not properly trained, which is to be addressed by the RDR, or again because the commission available on that particular product influenced the behaviour of the advisor into offering a product that did not meet the financial needs of the customer. Either way the principal problem here is not the product itself, but the appropriateness of the advice relating to that – and we therefore suggest that your approach would be both more fair and more effective if it focuses on enforcing new regulations on financial advice.

If the FSA is minded to pursue an approach based on products and their availability to certain investors, we would urge them to proceed with extreme caution. Of particular concern is the reference in 1.2 and elsewhere that refers to 'changing the financial promotions rules to limit the type of customer to whom firms may promote financial promotions for UCIS and *closely substitutable investments'.* It is the italicised wording that gives us most cause for concern, as it is not clear what the reach of the term is likely to be and therefore what products and investment vehicles are likely to be caught. We are concerned that this is a major philosophical change that fundamentally limits investor choice in a manner that seeks to dictate investor behaviour, whether they like it or not, rather than to ensure that the advice that they get is appropriate.

The consultation is designed to be pre-emptive [para 1.16], “in order to prevent consumer detriment occurring in the first place”, and indeed it sees the potential for harm as having arisen relatively recently, as “returns on more traditional investments... have been volatile and often disappointing for investors” [para 1.4]. This in turn “has prompted many consumers to consider alternative investment propositions”, including UCIS and close substitutes.

VCTs and EIS, however, do not fit this profile. VCTs were launched in 1995, have been in operation for 17 years, and 70% of the £4.6 billion funds raised by VCTs to date, were raised before the start of the current financial crisis in 2008.

Current fundraisings are running at around £300 million pa. EIS have a longer pedigree and continue to raise considerably larger sums.

A VCT is not, in fact, a trust but a public limited company whose shares are typically admitted to trading on the main market of the London Stock Exchange and listing on the Official List. Where they are traded on the London Stock Exchange, VCTs are subject to the premium listing regime and must comply with, amongst other things, a number of high-level "Listing Principles" contained in the Listing Rules.

The VCT investor base includes high net worth individuals and "ordinary" retail investors who subscribe for shares in VCTs ("VCT Shares") or (less often) acquire them in the secondary market. The importance of the retail investor base to VCTs is indicated by the fact that publicly available figures suggest that VCT fundraising could collapse by 75 per cent if VCTs are caught by the proposals[2].

While investors are exposed to risk by accessing the underlying asset class, this risk is no different to the risk displayed by many other investment products, some of which will not fall within the scope of the current proposals.

Para 1.5 states that “there are good reasons why these investments should not be considered mainstream”, and begins with the concern that, despite appearing lower risk, very often they are higher risk, speculative investments. Both EIS and VCT investors are provided with an attractive suite of tax breaks, specifically to compensate them for the risks involved in smaller unquoted companies. We do not have performance figures on EIS funds, though we have found little evidence of disastrous performance over the lengthy time that they have been in existence. The VCT industry’s track record over 17 years, meanwhile, proves that this balance

[2] Bestinvest survey, September 2012

of risk and return works. Funds equal to only 8% of the £4.6 million raised by VCTs since their launch, have seen a decline in value of over 50% of the amount subscribed, before income tax relief, and this figure falls to just over 1% after income tax relief. Many, by contrast, have performed strongly, with funds equal to 6% of the total raised achieving gains for investors of over 50% of the amount invested, before allowing for tax relief, and funds equal to 13% achieving gains of over 50% after income tax relief. This hardly constitutes "consumer detriment".

Para 1.5 goes on to state that "these investments are not subject to the rules governing, for instance, investment and borrowing power, disclosure of fees and charges, management of conflicts of interest, a prudent spread of risk and other investor safeguards". Para 1.6 goes on to say that "Risks to Capital are generally opaque and performance information may be unavailable or unreliable. Governance controls may be weak, heightening the potential for a product to fail".

EIS funds tend to have strong reporting systems and good transparency, even though they are not currently required to report in the same manner as quoted funds. As fully listed companies regulated by the UKLA, however, VCTs have independent boards, annual audit, extensive requirements on disclosure and a number of other investor safeguards, including limits on the size of individual investments. Performance and track records are fully analysed and annual accounts include extensive commentary by both the board and the manager. Importantly, shareholders are entitled to full face-to-face scrutiny of the board and manager at annual general meetings.

Para 1.6 expresses the concern that the funds invest in assets which "are not traded in established markets and which are therefore difficult to value". Although they invest in unquoted companies, the investment portfolio is valued by the independent directors, in accordance with the International Private Equity and Venture Capital Valuation Guidelines. These valuations are then subject to a full annual statutory audit.

Para 1.6 goes on to say that these investments "may be highly illiquid". This is correct for the majority of EIS funds and VCTs, where the policy objective of Government is to channel private investor money into UK unquoted companies. There are three safeguards, however. First, EIS funds are self liquidating, as it is the nature of EIS funds is to aim to return cash to investors over the life of the underlying investments; indeed it is the specific role of the investment manager to guide investee companies to maturity and ultimate sale or float. VCTs, by contrast, are mainly evergreen investment vehicles, though they must invest in a spread of investments, with no investment costing more than 15% of the fund's value. In this way, the risk of being unable to sell any investment when cash is required is reduced.

More importantly, however, was the original stipulation that VCTs must be fully listed on the LSE. This ensures that shareholders can dispose of their shares when required. Currently, an active secondary market in VCTs' shares is roughly matched by the ability of VCTs to buy in their own shares for cancellation.

A specific point on VCTs is that it is illogical to restrict the access of ordinary retail investors to new issues of VCT shares, when their fully listed status means that any investor may purchase shares in the secondary market without any restrictions whatsoever, though without the risk mitigation of the up-front income tax reliefs. This means that general retail investors who wish to invest in VCTs would be effectively forced down a higher risk route, to their detriment when compared to sophisticated and high net worth investors.

Para 1.11 states that "in a recent review of UCIS sales only one case in every four appeared suitable for the customer". Did this survey include EIS funds and VCTs? If so, what criteria were used to test "suitability"? If EIS funds and VCTs were not included, what level of investor complaints has the FSA received from EIS and VCT investors? Have these in any way matched the complaints on UCIS mentioned in 1.14? The industry's track record detailed in section 3 above suggests that this would be pretty low.

Para 1.12 states that "in some cases, providers have actively encouraged promotion to the general retail market". EIS funds and VCTs are specifically retail products. HM Treasury and HMRC designed VCTs so that the risks involved by a retail investor would be mitigated by generous tax breaks. Again, the analysis in section 3 above shows that the balance of risk and reward is fair.

In 2009, the FSA commenced a review of the financial promotions and advice processes for the sale of UCIS. The final report raised concerns and enforcement action was taken against a number of firms. The report led in turn to CP12/19.

In 2011 the FSA reviewed the website promotions for VCTs. Concerns were raised with a number of managers, who were asked to make the risks associated with VCTs more prominent. This was complied with promptly and, so far as we are aware, no enforcement action was deemed necessary. We have no evidence to suggest that this does not equally apply to EIS funds.

Given the other characteristics detailed above, including those designed to protect the interests of retail investors, it would seem unnecessary to seek to further restrict their promotion. Retail investors who are properly advised, or who choose to make their own investment decisions, and who are fully informed and aware of the associated risks should continue to have access to higher risk, but higher return, products.

Furthermore, the proposals catch products which are not distributed on an advised basis. PE/VC Shares, for example, are not available to the general public, but only retail investors connected with the relevant PE/VC fund. It is, therefore, inappropriate that they are subject to the proposals as the FSA's key policy concerns do not apply in this instance. It is not proportionate for the restrictions on promotion to extend into markets, and to regulate products, where there is no evidence of retail investor detriment.

VCTs are also subject to the requirements of Listing Rule 15 (*Closed-Ended Investment Funds: Premium Listing*) ("LR 15"). LR 15 imposes restrictions on the activities of the company. LR 15 requires a company to, for instance, "... *invest and manage its assets in a way which is consistent with its object of spreading investment risk*", publish an investment policy and ensure that its board of directors is able to act independently. Companies which fall within the scope of LR 15 must also publish an annual financial report setting out a number of details about the company's activities.

Given these stringent requirements, it is entirely unfounded to equate VCTs with UCIS. VCTs are not SPVs set up to avoid falling within the definition of UCIS; they are legitimate trading companies and there is no basis on which to differentiate VCTs from other listed companies. If listed trading companies fall outside the scope of the proposals, so too should VCTs.

No justification for equating VCTs and PE/VC NewCos with UCIS

The listed nature of VCTs is only one such example of why it is inappropriate to equate them with UCIS. Neither investments in VCTs, nor investments in PE/VC NewCos, display many of the characteristics which the FSA identifies (at paragraph 2.3 of the Consultation Paper) as typical of NMPIs. As such, they are non-comparable investment products and should not be subject to the same restrictions on promotion. Even where investments in VCTs and PE/VC NewCos do display these characteristics, so too do many other investment products and vehicles which will fall outside the scope of the rules.

"*They feature complex or opaque investment strategies, structure, features, or terms and conditions, such that ordinary retail investors are unlikely to fully understand or be able to adequately assess the investment proposition and its risks*". VCTs do not feature complex or opaque investment strategies – they invest in a portfolio of small companies and are subject to clear limits on the investee companies' size. VCTs are required by the Listing Rules to disclose their approach to investment in an investment policy and, on launch and for other relevant share issues, are required to issue prospectuses in accordance with the Prospectus Rules. As such, sufficient information is available for retail investors, and their advisers, to make informed decisions about the investment proposition. Similarly, while PE/VC investment strategies can be more complex, they too set out to invest in unquoted companies to maximise the returns for investors. In a PE/VC scenario, the retail investors will be management of the target company and, as they will be closely connected with the PE/VC fund, will be well-placed to assess the investment proposition and its risks. Even where VCTs or PE/VC funds do utilise complex strategies or structures or have complex features, terms or conditions, so too do other investment vehicles not subject to the restrictions on promotion.

"*They are difficult to value accurately (so that their valuations require specific skills or systems)*". In the context of VCTs, as their shares are traded on public markets, the mechanics which govern public markets provide price transparency. In terms of the underlying value of the assets in which they invest, VCTs publish details of the Net Asset Value of their portfolio which provides price transparency in relation to the underlying assets. PE/VC Shares may be more difficult to value but, given that the retail investors who hold these securities will be management of the target company, they should be well placed to assess and understand the relevant valuations.

"*Their product structures are less regulated and therefore likely to hold greater operational and governance risks for investors*". While neither VCTs nor PE/VC NewCos are directly regulated by the FSA, they are, nonetheless, regulated by company law and, in the context of listed VCTs, subject to the listing rule regime. Furthermore, VCTs and many PE/VC funds (if not PE/VC NewCos themselves) will be within the scope of the AIFMD when it comes into force and many will be subject to the PRIPs Regulations. It is, therefore, incorrect to suggest that either their product structures are less regulated or that they are, by their very definition, likely to hold greater operational and governance risks for investors.

Arbitrary differentiation between similar investment products

The draft rules arbitrarily differentiate between investment products which achieve substantially the same outcome for retail investors. The draft rules allow retail investors to invest in, for example, investment trusts, but not VCTs, despite there being many similarities between both the investment proposition and nature of the investment vehicle. Given that one of the purposes of the RDR was to introduce a more level playing field between retail-orientated products, it seems inappropriate for the current proposals to make such arbitrary differentiations.

Similarly, the proposals do not seek to regulate indirect holdings of NMPIs. As such, retail investors may still be exposed to the risks about which the FSA is concerned. The proposals do not seek to restrict retail investors' investment in, for instance, UCITS and NURS even though such investment products can expose investors to risks. Regulated CIS may, for instance, hold UCIS as a proportion of their underlying investments and unit-linked insurance funds can hold up to 20 per cent in UCIS, subject to certain requirements.

The proposals appear more concerned with form than substance and will not achieve a degree of consumer protection commensurate with the adverse effects caused. While we recognise that not all investments in VCTs (and, similarly, REITs and other vehicles) will be suitable for all investors, this is a characteristic they share with investment products which will fall outside the scope of the rules, including investment trusts, UCITS and NURS. There is nothing inherently problematic in VCTs (and other similar vehicles) which means they should be treated any differently to investment trusts, UCITS, NURS or direct shareholdings in trading companies.

Reliance on FSA Glossary definition of "SPV" renders draft rules too wide in scope

As outlined above, reliance on the FSA Glossary definition of "SPV" in the definition of "NMPI" renders the draft rules unclear, potentially extremely wide in ambit and means that a number of legitimate retail investment structures may, potentially, be brought within the scope of the rules.

In particular, as investment trusts have been specifically carved out of paragraph (c) of the definition of "NMPI", this suggests that, without such carve-out, the FSA would consider shares issued by investment trusts to be securities issued by an SPV. If an investment trust is capable of constituting an SPV, so too may many other investment vehicles, including VCTs, non-UK investment trusts and PE/VC NewCos. Indeed, it is not clear why any company should not fall within the definition.

We would contend that neither a VCT, a non-UK investment trust nor a PE/VC NewCo is an "SPV" as contemplated by the FSA Glossary definition. Neither VCTs, non-UK investment trusts nor PE/VC NewCos are body corporates explicitly established for the purpose of securitising assets and none of these types of vehicle has, as its sole purpose, any of the functions set out in the FSA Glossary definition. Indeed, investment companies in general should not be regarded as SPVs.

As the proposals are intended only to catch UCIS and 'close substitutes' of UCIS, the rules should, if they are to be enacted at all, be much narrower in scope. Either a different definition of "SPV" should be used or, at the very least, VCTs, non-UK investment trusts and PE/VC NewCos should be carved out of paragraph (c) of the definition of NMPI. We anticipate that other respondents would also seek to be carved out, such as REITs.

Without amendment, the draft rules are far broader in scope than is proportionate based on the policy concerns and evidence of retail investor detriment put forwards in the Consultation Paper or in the CBA. While we appreciate the FSA's concerns about regulatory arbitrage, such concerns should not result in legitimate investment vehicles, which have not been incorporated simply to avoid falling within the definition of UCIS, being subject to the restriction.

Effective ban on promoting certain Close Substitutes to all retail investors due to narrow scope of FPO exemptions

The Consultation Paper suggests that the ban on marketing NMPIs will apply only in the context of marketing to "ordinary" or "average" retail investors. It suggests that marketing to high net worth or sophisticated retail investors will still be allowed. While this is correct in relation to UCIS, it is not correct in the context of certain Close Substitutes where there will be an effective ban on the promotion of such investments to all retail investors.

Under the draft rules, FSA authorised firms wishing to promote Close Substitutes will be able to do so if the financial promotion is an "excluded communication". "Excluded communications" include financial promotions that would benefit from an exemption in the FPO. The relevant exemptions in the FPO, and the ones contemplated by the Consultation Paper and the draft rules, are those set out in Articles 48 (*Certified high net worth individuals*), 50 (*Sophisticated investors*) and 50A (*Self-certified sophisticated investors*) of the FPO.

The exemptions contained in Articles 48 (*Certified high net worth individuals*) and 50A (*Self-certified sophisticated investors*) of the FPO, however, apply only where the subject matter of the promotion constitutes: (i) shares in an unlisted company; or (ii) units in a collective investment scheme ("CIS") which invests wholly or predominantly in the stock or shares of unlisted companies. Given that a VCT is neither an unlisted company (as defined) (being a company whose shares are traded on a regulated market or, potentially, AIM) nor a CIS, it will not be possible for FSA authorised firms (or, indeed, non-FSA authorised firms) to rely on either of these exemptions to promote VCT Shares to high net worth or sophisticated investors.

The exemption contained in Article 50 (*Sophisticated investors*) of the FPO requires an unconflicted FSA authorised firm to provide a certificate as to the recipient's sophistication in relation to a particular category of investment. Subject to the FSA's proposed new Guidance, third parties are entitled to rely on this certificate and make otherwise prohibited financial promotions to the relevant individual. In practice, however, this exemption is seldom used. There is a general reluctance on the part of authorised persons to certify investors as sophisticated because of their (the authorised person's) exposure to potential liability if incorrect certification is carried out. The proposed Guidance further limits the utility of this exemption by increasing the burden on the firm proposing to give the certification.

Effective ban on promoting PE/VC Shares to management of target companies due to reliance on FPO exemptions and effect of Guidance

As outlined above, management of target companies in PE/VC deals often acquires shares in one of the holding companies in the structure as part of their incentivisation package.

As explained above, under the draft rules, PE/VC NewCos may potentially constitute Close Substitutes. As members of the management team are unlikely to be high net worth or sophisticated investors, it would be necessary for the firm making the promotion to rely on the exemptions contained in Articles 28 (*One off non-real time communications and solicited real time communications*) or 28A (*One off unsolicited real time communications*) of the FPO in order to promote PE/VC Shares to management.

If, however, this promotion is carried out by an FSA authorised firm (as will often be the case), it will be required to take into account the Guidance when considering whether to make the promotion. The Guidance relating to these exemptions requires the firm making the promotion to have regard to its duties under the FSA's Principles and the client's best interests rule and to consider whether the promotion is in the interests of the client and whether it is fair to make the promotion. The Guidance further states that, "*... in the FSA's view, promotion of a non-*

mainstream pooled investment to a retail client who is not a certified high net worth investor, a certified sophisticated investor or a self-certified sophisticated investor is unlikely to be appropriate or in that client's best interests". As such, FSA authorised firms are unlikely to be able to rely on these exemptions to promote PE/VC Shares to members of management teams. Given that these are the only relevant exemptions in the FPO in this context, this effectively prevents the remuneration and incentivisation of management from continuing to operate as it currently does. No evidence is presented in the Consultation Paper as to detriment suffered by such investors making this restriction disproportionate and unjustified.

While promotion of PE/VC Shares could, at least technically, be carried out by a non-FSA authorised firm (as it would not be subject to the Guidance, see further discussion on this point below), it is unlikely that such a firm would undertake this type of promotion due to it clearly being contrary to the draft rules.

Guidance undermines relatively objective nature of statutory exemptions in FPO and PCIS Order and reverses burden of proof

The Guidance will require FSA authorised firms not only to consider the legislative requirements of the relevant exemptions in the PCIS Order (in relation to UCIS) and the FPO (in relation to Close Substitutes) but also to satisfy themselves that the relevant promotion is fair and in the best interests of their customers. This introduces a more subjective limb to the relevant tests, thereby undermining the relatively objective nature of the current approach.

Not only are we concerned that the additional requirements will increase the regulatory burden on, and risk of non-compliance by, FSA authorised firms but we consider that the Guidance in relation to high net worth and sophisticated investors fundamentally cuts across the policy reasoning behind the introduction of these exemptions.

The exemptions were introduced in order to make it easier for companies to approach and attract investors, go some way towards helping to build a more enterprising culture, create the best possible environment in which to start and grow a business and tackle barriers to successful SME formation and growth (*Informal capital raising and high net worth and sophisticated investors: Changes to the Financial Promotion Order: Government Response* (November 2004)). The Guidance significantly limits the ability of firms to approach such investors and, by doing so, means that the regulatory regime cuts across the underlying policy approach.

Guidance creates unlevel playing field between FSA authorised and non-FSA authorised firms

The existence of the Guidance creates an unlevel playing field between FSA authorised and non-FSA authorised firms. In the context of the FPO exemptions, which both FSA and non-FSA authorised firms will be required to rely upon when promoting Close Substitutes, only FSA authorised firms will be required to have regard to the Guidance when determining whether an exemption applies. In contrast, non-FSA authorised firms will not be required to undertake the more subjective analysis contained in the Guidance as they are not subject to the FSA's Rules.

By way of example, a non-FSA authorised firm would, at least technically, be able to rely upon the one-off exemptions in the FPO when promoting a Close Substitute to an "ordinary" retail investor. As the firm would not be required to take into account the Guidance, it would be able to rely on the relevant exemption and make a one-off promotion to such investor. In contrast, an FSA authorised firm would be required to take into account the additional requirements set out in the Guidance and, as the FSA considers that promotions of Close Substitutes will rarely, if ever, be suitable for retail investors, could not rely on the relevant exemption to promote a Close Substitute to an "ordinary" retail investor.

While we do not think that the Guidance is appropriate, if it is to be introduced, we consider that it should be included in PERG rather than COBS in order to create a more level playing field.

Uncertainty around execution-only sales

The effect of the proposals on execution-only sales of NMPIs is unclear. The Consultation Paper, at paragraph 1.25, provides that the draft rules do not include execution-only sales, "*if there has been no financial promotion of the non-mainstream pooled investment*". The drafting of this paragraph would suggest that "ordinary" retail investors could invest in an NMPI if there had been no financial promotion of the relevant product. Given that elsewhere in the Consultation Paper, and in the draft rules, the FSA makes clear that it assumes NMPIs will rarely (if, indeed, ever) be appropriate for "ordinary" retail investors, it is not entirely clear whether this is the intended effect.

Notwithstanding this uncertainty, there is a more fundamental issue. Under the Packaged Retail Investment Products Regulations (the "PRIPs Regulations"), proposed by the European Commission, product manufacturers of PRIPs will be required to produce a 'Key Information Document' ("KID") for those products which they intend to make available to retail investors. The requirement to produce a KID will extend to those products where product manufacturers cannot control access to the product. Such requirement fundamentally cuts across the current proposals.

It is likely that many NMPIs will constitute PRIPs. Even if the NMPI in question is not targeted at retail investors, where the product manufacturer cannot control access to it, it will be required to produce a KID. Given that a KID may well constitute a financial promotion: (i) the product manufacturer will potentially breach the current proposals by promoting an NMPI to "ordinary" retail investors; and (ii) the very existence of the KID effectively prevents execution-only sales to retail investors as a financial promotion in respect of the product will have been made.

Problematic interaction with other legislative changes

The problems outlined above in relation to the problematic interaction between the draft rules and the PRIPs Regulations are not an isolated example of the draft rules cutting across, or not sitting well with, other legislative changes. Many NMPIs, including PE/VC funds and VCTs, will fall within the scope of the Alternative Investment Fund Manager's Directive (the "AIFMD") when it comes into force. Other changes, such as the RDR, are also in train and will impact upon the promotion to retail investors of products which constitute NMPIs.

As many of these legislative changes will not only significantly affect the investment landscape but may also go some way to resolving many of the FSA's concerns, introducing further regulations before the effects of these changes have been fully assessed and understood seems unnecessary. If the proposals are to be introduced, it will be necessary to ensure that they do not undermine, and are not undermined by, other legislative changes.

Responses to questions set out in the Consultation Paper

We have not answered every question set out in the Consultation Paper but only those which we consider to be relevant to the PE/VC industries. Where appropriate, we have included cross-references to the relevant paragraphs of our narrative above rather than duplicate points already made.

Q1. Do you agree that we should look to impose restrictions on the promotion of non-mainstream pooled investments to ordinary retail investors?

As discussed above, while we fully support the FSA in its efforts to protect consumers from mis-selling, we do not agree with the current proposals in either substance or form.

While we have assumed that the drafting of the proposals renders them far wider in scope than was intended, notwithstanding this assumption, we consider that the FSA's concerns would be better addressed through enhanced monitoring and enforcement in the advisory marketplace and further embedding the RDR rather than targeting the underlying investment products themselves.

Ordinary retail investors who are either properly advised or who choose to make their own investment decisions should continue to have access to higher risk, but higher return, investment products.

Q.2 Are there any other investments that should be treated in the same way?

As discussed above, we consider that the proposals are already far broader in scope than is justified.

Q.3 Are there any investments caught by the non-mainstream pooled investment definition in the draft rules that you believe should not be?

As discussed at paragraphs 18 to 22 above, we are particularly concerned that the proposals catch VCTs, non-UK investment trusts and PE/VC NewCos. We also note that the proposals catch REITs (although we note that these investment vehicles are not within our membership). We consider it likely, given that reliance on the FSA Glossary definition of "SPV" renders the definition of NMPI extremely broad, that a number of other legitimate investment structures will also be caught. We would strongly contend that the proposals should be withdrawn in their entirety but, if this is not to be the case, we would suggest that a different definition of "SPV" is employed and/or additional carve-outs are included.

Q.4 Do you agree that we should remove the general ability of firms to promote UCIS under COBS 4.12.1R(4) category 1?

We have no specific comments from the perspective of the PE/VC industry.

Q5: Do you agree that firms should still be able to promote replacement UCIS to retail customers where the original product is being replaced or liquidated?

We have no specific comments from the perspective of the PE/VC industry.

Q6: Do you agree that we should remove the ability of firms to promote UCIS under COBS 4.12.1R(4) category 2?

We have no specific comments from the perspective of the PE/VC industry.

Q7: Do you agree that we should remove the exemption in COBS 4.12.1R(4) category 8?

We have no specific comments from the perspective of the PE/VC industry.

Q8: Do you agree that we should limit the ability of firms to promote QIS, securities issued by SPVs and TLPIs in the retail market?

The BVCA does not represent QIS or TLPIs and, as outlined above, our concerns relate predominantly to securities issued by SPVs (where SPVs may include VCTs and PE/VC NewCos). As discussed above, we do not consider that a restriction on promotion is a suitable response to the underlying policy concerns and that, instead, the FSA should focus its response in the advisory marketplace. As currently drafted, the proposals will catch investment products for which there is no evidence of retail investor detriment and will unfairly restrict the choices open to retail investors.

Q9: Do you have any comments or suggested improvements for our approach to SPV-issued securities, including structured products?

Please see our answers to questions 3 and 8 above. As discussed, the current approach to SPV-issued securities is fundamentally inappropriate as it catches investment structures which cannot legitimately be equated with UCIS.

Q10: Do you have any comments on the Handbook guidance we propose to add regarding the use of exemptions in the FPO and PCIS Order?

Please see our comments at paragraphs 33 to 38 above.

Q11: Do you agree that we should require firms to retain a record of the basis on which the promotion of a non-mainstream pooled investment has taken place for each financial promotion?

We agree that firms should be required to maintain proper records in respect of the promotion of investment products but consider that the current proposals are unduly burdensome. Furthermore, it is unclear to us how further record-keeping will achieve any greater degree of consumer protection. Such record-keeping will be prohibitively expensive and only serve to further increase the compliance burden on firms who should instead focus already stretched resources on their investment activities.

Q12: Should we require confirmation of compliance with the marketing restriction for each promotion?

We do not think that such confirmation should be required. Not only will this serve to further increase the regulatory burden on firms but, more importantly, if an individual is made personally liable for confirming compliance, firms are likely to experience significant difficulties in finding individuals willing to perform such a function.

Q13: Do you agree that the CF10 individual is the correct person to confirm compliance?

Please see our answer to question 12 above. We think such confirmation of compliance is wholly inappropriate.

Q14: Do you have any comments on the Handbook guidance we propose to add regarding the link between promotion and advice?

We have no specific comments from the perspective of the PE/VC industry

Q15: Do you agree with our proposed update to the retail investment product definition?

We have no specific comments from the perspective of the PE/VC industry.

Q16: Do you have any comments on the impact of our proposals on existing customers and the distributor firms serving them?

We consider that the proposals will unfairly restrict retail investors' choice by limiting the types of investment products which may be promoted to them. Investment in, for instance, a VCT can benefit a retail investor by broadening their portfolio and allowing them to access asset classes they may not otherwise have access to.

Q17: Do you have any comments on our analysis of non-mainstream pooled investments?

We would argue that the analysis is seriously deficient as it does not recognise all investment products which may constitute NMPIs.

Q18: Do you have any further data on the size of the market?

We would argue that, given that a much broader range of investment products potentially falls within the scope of the rules than is recognised by the Consultation Paper, the market is much larger than is suggested.

Q19: Do you have any comments on our overall strategy to deal with the risks to retail customers of investing in UCIS?

As outlined above, we consider that the overall strategy is fundamentally flawed as there is a misalignment between the nature of the problem and the nature of the proposed solution.

The problem which the proposals aim to address appears to be one of failure to enforce the existing rules rather than an inherent failure in the design of those rules. As such, bringing more investment products in scope is neither a proportionate nor appropriate response. As the root cause of the problem lies in the advisory marketplace, where retail investors have been receiving recommendations to invest in products which may not be suitable for their investment needs, a more suitable response would be to focus efforts in this area.

We would suggest that the FSA focuses on enhanced monitoring and enforcement in the advisory marketplace and further embedding of the rules regulating advisers, including the ban on commission and the requirements for advisers to achieve a higher standard of qualifications, as established by the RDR, rather than introducing further regulatory change.