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Mr. Jouko Marttila
Committee of European Banking Supervisors
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25 Old Broad Street
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16 June 2006

Dear Mr Marttila,

**Questionnaire on market practices on Large Exposures 26 March 2006**

The British Venture Capital Association ("BVCA") is responding to the invitation to submit views on the above. The BVCA represents over 180 UK-based private equity and venture capital firms. Last year, the funds raised by the UK private equity industry amounted to over 50% of the private equity funds raised in Europe. British private equity funds invested over £10 billion in European companies last year, of which over £4 billion was invested in European countries other than the UK.

**Private equity**

The classic business model for a typical firm is essentially very simple; it involves a relatively small number of highly skilled staff responsible for advising on and managing portfolios of private equity and venture capital investments and arranging the making of such investments, supported by a few technical/administrative staff. Firms may also be established to act as advisors to other firms.

Private equity and venture capital firms in the United Kingdom are regulated by the Financial Services Authority. Most are categorised by the FSA as falling within the lowest risk category for a number of reasons including:

(a) the regulated private equity manager/adviser does not take positions in investments as principal;

(b) the regulated private equity manager/adviser only acts for professional clients, not retail investors;

(c) the managed funds invest in equity and debt instruments issued by private companies. Accordingly the dealing and management activities are not comparable to the activities of a manager of liquid quoted stocks as they do not give rise to the same risks. A typical transaction may take some months of negotiation, always involving external lawyers and accountants. As the investments are in unquoted companies, it would be very difficult for investments to be deliberately or negligently misplaced or appropriated;

(d) the managed funds are often structured so that the venture capital firm does not hold client money or assets;

(e) the terms on which the funds are established and the manager acts are generally the subject of genuine negotiation between large well resourced institutional investors and the manager. As a result the controls on and reporting required of a manager are both tailored to the investor's needs.

**Application of the Large Exposures regime**

The question of principal relevance to the UK private equity industry in the CEBS questionnaire is:

*15. Please set out your experience of, and views concerning, the current large exposures regulatory regime.*

A number of venture capital and private equity firms are subject to the large exposures requirements set out in the Capital Adequacy Directive (93/22/EC) and will continue to be subject to these requirements following implementation of the Capital Requirements Directive. Many of these firms have significant issues with the Large Exposure requirements.

When a firm starts business, it is common for the firm to have a small number of regulatory clients, normally just the first fund which it raises from third party professional investors. A firm typically manages a fund over a period of 5-10 years. Firms may subsequently raise additional funds and may also provide discretionary portfolio investment services to clients such as pension schemes.

Firms are typically paid a percentage commission based on the value of assets under management. This is normally paid in arrears. Firms can find that they are required to accrue fees earned but unpaid, in which case they must treat the accrued fees as an "exposure". (These accrued fees can alternatively be deducted in full from capital as an illiquid asset, but as this is a harsher treatment than the large exposures requirements, most firms structure their fee arrangements to avoid this). The "exposure" is in fact an exposure to clients. For a start-up firm, the exposure is an exposure to its sole client, the first fund. The large exposures rules require a firm to hold capital to cover the possibility that its sole client might not pay those fees. Under the current rules, this capital must be equal to at least 4 times the maximum value of the exposure. This level of capital is significantly in excess of the economic capital required to operate the firm.

Where a firm is raising a new private equity fund, it may accrue an asset reflecting the costs incurred in the fund raising (which is normally reimbursed by the fund once the fund closes). This amount will be an exposure. This means that a firm raising its first fund can risk breaching the large exposures limits before it even has its first client.

This has the effect of imposing a significant barrier to entry for new firms. It also means that firms who are successful need a higher level of capital to cover the increasing exposure value (as accruals will increase in line with the amount of funds under management). In some cases it may be possible to conclude that the accounting treatment does not require accrual before payment is due. In other cases a regulator might accept that such a rule breach is purely "technical", in the sense that the regulator may recognise that it poses no threat to customers. Where these routes are not available, many firms hold capital beyond the required economic capital. Many also structure their client relationships so they are paid in advance or at shorter intervals than would otherwise be required for commercial purposes to avoid accruing the exposure or keep it within the limits. The irony of this is that the regulatory rules mean customers pay fees earlier than they would without the rules.

**No policy justification for applying these rules to private equity**

In our view it is inappropriate to apply the large exposures regime to private equity firms; it is simply not an appropriate risk mitigant. For banks, the large exposures regime supports the policy goal of



protecting depositors through ensuring that the bank does not overexpose itself to a single counterparty or group of counterparties. For banks and investment firms which take exposure through trading as principal, the large exposures regime also serves to protect against the systemic risk in institutions taking exposures to a single counterparty or group of counterparties. The regime thus serves to protect individual investors/depositors and support the market as a whole.

Applying the same regime to private equity firms does not confer any benefit on investors in private equity funds or the market as a whole. Were a client to fail to pay an investment manager a significant amount which would result in the investment manager being unable to continue in business, this would have no effect on the value of the underlying funds managed by the investment manager. All that would happen is that responsibility for management of those funds/discretionary mandates would be taken over by a solvent fund manager.

In practice, it is virtually inconceivable that a client would fail to pay the fund manager in any case, for a very simple reason: the manager is paid out of the assets which it controls through its discretionary investment mandate. The only circumstance in which the manager might not recoup the exposure is if the fund is not raised, in which case there is no regulatory client to protect through imposing a large exposures requirement.

The risk for investors in funds managed by an investment manager is that the manager fails to make the correct investment or that there is some fraud or negligence resulting in a loss of the investment. There are two mechanisms to address this risk. The principal regulatory mechanism is conduct of business-style rules. There is also a significant market mechanism. This takes the form of considerable due diligence by potential investors on the private equity manager. This means that investors have the opportunity to assess the capitalisation of the firm. However, this is likely to matter little to investors precisely because private equity firms do not take principal positions so do not expose themselves to insolvency though market exposures. Instead, investors care about the ability of the private equity firm's investment team to spot a good investment, help it to grow over a period of a number of years (typically 3-7) and then realise the investment. They are not to our knowledge interested in the (potential) level of its large exposures.

One argument which is sometimes advanced to justify applying large exposures rules to private equity manager firms is that this creates a "level playing field" between those firms and banks/principal traders which wish to compete in the investment management market. This is mistaken. Banks and principal position takers pose the policy risks referred to above, whatever additional business lines they pursue. So where they pursue additional business lines (such as private equity management) it is right that the Large Exposures regime should apply to cover those activities, in accordance with the public policy interest in protecting depositors and market stability. That might of course require banks to consider whether to pursue these business lines at all, given the need to allocate risk capital to them. However, it does not follow that risk capital requirements should be applied to firms which present completely different public policy issues. For the reasons given above, we do not think that large exposures requirements are an appropriate risk mitigant for pure private equity firms, just as conduct of business rules would not be an appropriate risk mitigant for a pure deposit taking business.

The existing regime puts both firms and regulators in a difficult position. It is plainly not suited to the regulation of investment managers and yet it is mandated by directive. It is very important that this position be rectified as soon as possible.



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**Policy Recommendation**

The concept of "limited licence firm" in the Capital Requirements Directive recognises the distinction illustrated above between the risks posed by on the one hand by banks and principal dealers and on the other hand by investment management firms. In our view, the large exposures regime should simply not apply to limited licence firms. To the extent that any capital requirement is appropriate, this is imposed in the form of the Fixed Overheads Requirement, supplemented by Pillar II.

At the very least, we believe it is crucial that exposures relating to fees due for investment management activities performed by "pure" investment managers are not subject to a large exposures requirement.

Please do not hesitate to contact me on 020 7295 3233 or Tim Lewis on 7295 3321 with any queries on this letter.

Yours sincerely,

Margaret Chamberlain

Margaret Chamberlain
Regulatory Committee Chairman
British Venture Capital Association

CC: Felicity Benson, Financial Services Authority
Gemma Temple-Smithson, HM Treasury