

3 Clements Inn
London WC2A 2AZ

T 020-7025 2950
F 020-7025 2951

bvca@bvca.co.uk
www.bvca.co.uk

21 January 2005

The Committee of European Securities Regulators ("CESR")
11-13 avenue de Friedland
75008 PARIS
FRANCE

via CESR's website: www.cesr-eu.org

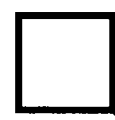
Ladies and Gentlemen

**CESR'S DRAFT TECHNICAL ADVICE ON POSSIBLE IMPLEMENTING MEASURES OF
MIFID - SECOND SET OF MANDATES - OCTOBER 2004 CONSULTATION PAPER**

The British Venture Capital Association (BVCA) is responding to the invitation to submit views on the above. This response follows on from, and is intended to be considered in the context of, the BVCA's responses dated 17 September 2004 and 16 December 2004 to the CESR consultation paper on the first set of mandates.

As we have noted in previous submissions, the concerns of the venture capital/private equity industry are often significantly different to those of other market participants. This paper comments only on those aspects of the consultation paper which we believe are of particular importance and relevance to venture capital/private equity firms. We note that a substantial part of the advice is based on CESR Standards. As CESR knows these Standards have not been implemented in Member States and were not drawn up with the private equity market in mind. We do not therefore think that the Standards should necessarily drive the advice in this area.

We must repeat a point that we have made previously, which is of the utmost importance in the private equity sector. The definition of professional client in MiFID is not appropriate for the private equity industry - a person who does not fall within the mandatory framework for assessment as a professional client will probably never fall within the optional framework. This is because at least two of three criteria must be met - one of which is probably never capable of being met in a private equity scenario. No professional private equity firm executes on average ten transactions per quarter - an investor could therefore never hope to reach such a target. There are therefore a large number of sophisticated persons with expertise in the private equity market, who are, under any usual understanding, "professional" but who will fall to be treated as retail clients by virtue of the restrictive nature of the definition in MiFID.



It is for this reason that CESR must recognise in its final advice that there is a wide range of persons caught within the concept of retail client and that it is both necessary and proportionate to calibrate the advice relating to retail clients, so that it takes into account this range of possible clients. Otherwise the private equity industry will suffer significantly compared with other industries - it may not be able to access, or may experience more difficulties in accessing investors who are professional in the private equity marketplace. For example, executives who have worked in venture capital firms and entrepreneurs who have been backed by venture capital firms often have a significant understanding of the nature of issues associated with private equity investments; it is essential that firms are able to deal with them taking into account their understanding. This is relevant in a number of areas, some highlighted in previous submissions - and is particularly relevant to the issues raised by this consultation paper - in the context of personal recommendations, suitability and execution only services.

We have recently written to Mr. Comporti, following the open meeting held in December, when we again highlighted the particular issues that we have. As mentioned at that meeting, and reiterated in our recent letter, we would be more than happy to meet with representatives of CESR to explain the points we have made, if this would be considered helpful.

INVESTMENT ADVICE

There are three particular issues for private equity firms.

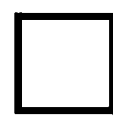
The first concerns the position when such firms are marketing to raise new funds for management, and in doing so are engaged in discussions and negotiations with potential investors. The second concerns the exact scope and meaning of investment advice when the advice is not given to an individual investor. The third concerns its implications for the relationship between firms and investees.

Personal Recommendation

“All relevant circumstances” - a key concept

As a general comment we support CESR in its view that investment advice must be defined in a proportionate manner. It is particularly important in the private equity context that certain activities, which are not in the nature of personal recommendations to investors in their capacity as investors, are not inadvertently caught by the definition of investment advice. The consequences would represent a considerable burden on private equity firms without a corresponding investor benefit. This highlights the correctness of CESR’s comment that there is a very wide range of activities that need to be measured against the definition of investment advice and that the definition should therefore contain an appropriate level of flexibility and enable all relevant circumstances to be taken into consideration in determining whether advice has been provided. **The concept of “all relevant circumstances” is so important, particularly in the private equity context, that we believe it should be included in the actual definition.**

We agree that the definition has to be designed for the purposes of MiFID and that the definition of recommendation under the MAD, is not particularly relevant in this context.



We note (and agree) that advice on services does not fall within the concept of personal recommendation. The CESR advice notes that advice on the amount of assets to invest could be a personal recommendation. It is not clear to us that advice on proportions of a portfolio to be invested should itself be a personal recommendation. We would have thought that advice on an amount to be invested would have to be linked to a particular security for the advice to amount to a personal recommendation.

Question 1.1 - We agree that advice on services, such as recommendations to use a particular broker, etc are not covered by the concept of personal recommendation.

Marketing Activities

In the context of marketing activities by venture capital/private equity firms to potential investors, there will usually be both documentation and face to face meetings provided to the prospective investor (in this context, an investor is a person who is considering placing funds for management with the private equity firm). The contact is close and may continue over a period of time. The investor will be doing its own extensive due diligence on the private equity firm. The private equity firm may assist the investor by producing information about the nature of private equity investment, historic returns, etc. However, the overriding hallmark of the relationship is that the investor is not under the impression that he is receiving investment advice from the firm - in all of the circumstances, it is clear to him that the firm is engaged in a marketing exercise (under which it may indeed have liabilities both at general law and under a regulatory framework). However, the investor is not under the impression that he has been given advice based on an understanding of his circumstances, and on the acceptance of a responsibility to him to give him advice.

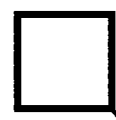
For these reasons, we support CESR in its approach that the assessment of the nature of a communication needs to consider the overall effect of all of the circumstances surrounding the communication.

Definition

Therefore, we support CESR in its approach, but consider that the approach needs to be more fully reflected in the proposed definition. In addition, the definition needs to incorporate within it the concept as to whether it is reasonable on the part of the recipient to assume that he is being given advice - and again, what it is reasonable to understand, will depend on all of the circumstances. The definition should not refer to information given - it is not information that is the issue.

We would further comment that the issue of a bilateral communication or relationship is only a potentially relevant circumstance. A firm may have many bilateral contacts which do not mean that investment advice is being given - in particular, in the example given above, the marketing involves close bilateral communication - but this does not of itself mean that there is a personal recommendation being given.

We suggest therefore that the definition of investment advice, in the first paragraph reads as follows:



“personal recommendation means any communication to a person (which may include a value judgement or opinion or recommendation [to buy/sell etc.] that is reasonably understood by the recipient to be based on a consideration of his personal circumstances and on an assumption of responsibility towards him by the firm in respect of the suitability for him of the relevant transaction. In determining what would be reasonable for a recipient to understand all relevant circumstances must be taken into consideration, including but not limited to the identity of the recipient, any disclaimer in the communication, the nature of the existing and general relationship between the firm and the recipient including the existence of any contract and also on the need to distinguish between communications of a promotional nature and communications which imply the acceptance of a duty to provide personal recommendations.”

Other Issues

There are issues, however, which still remain to be resolved which are of considerable relevance to private equity/venture capital firms. These are:

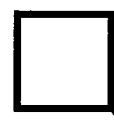
1. It is not clear whether a firm which is an investment adviser to an investment manager is to be considered as providing investment advice. This point needs to be clarified.
2. By their very nature, many private equity/venture capital firms are closely involved with the ongoing business of the companies in which they have invested. Such activities might, but will not necessarily involve ancillary services; which are in any event not always subject to regulation. It seems to us that there are many general advisory-type activities which may involve neither a personal recommendation nor an ancillary service, and which may be freely provided without any investor protection issues arising. It is important that the definitions do not inadvertently cover the support and advisory services which private equity investors provide to their investees - such activities do not involve investor protection issues and the imposition of conduct of business and similar requirements to such activities would impose a considerable and disproportionate burden on investment activity and on the ability of private equity firms to help their investee companies flourish and prosper. The critical point is to ensure that personal recommendations relate to 'investors' in relation to transactions.

Recommendations etc.

Given that CESR has been asked to advise on criteria for the same, we have the following comments.

Recommendation

A recommendation may be a communication which indicates that a transaction or transactions will be desirable or beneficial - but such an indication is not of itself sufficient to elevate such a communication into a personal recommendation within the meaning of investment advice. For example, marketing documentation may contain statements akin to suggesting that in some cases a particular transaction may be desirable - this will not necessarily elevate the communication to a personal recommendation. It is important that it



is recognised that all relevant circumstances need to be considered in assessing the status of any such indication.

Marketing communication

A marketing communication in a private equity/venture capital context is, as CESR indicates, generally not issued on a client's request but is at the initiative of the investment firm. However, we would point out that in the dialogue which can take place following a marketing communication, further information may be requested. This is undoubtedly still in the nature of a marketing communication - but it has been requested by the prospective client.

Information given to the client

Some information given to a client may make a comment or value judgement on its relevance for an investment decision. For example, a private equity firm might provide information on performance of private equity as against other asset classes and comment that such performance might be relevant to be considered in the context of an investor's overall portfolio. The fact that the comment or value judgement is made does not of itself turn the provision of information into a personal recommendation. Again, the point made above is key - is it reasonable of the investor in the circumstances to consider that he is being given a personal recommendation - is he under the impression that the firm has assumed a duty to him?

For all of these reasons, it is important that CESR's advice on criteria for differentiating between the different types of communication is not expressed to be conclusive - we support CESR in its consideration that any communication needs a case by case consideration - there can only be guidance on general factors that might be relevant in distinguishing these communications from personal recommendations.

OBLIGATION TO ACT FAIRLY, HONESTLY AND PROFESSIONALLY

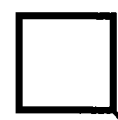
It is not clear to us why either of the proposals are suggested in relation to portfolio management. It seems to us that they are already covered under the general requirements and more detailed requirements imposed on firms. In particular, we do not understand the concept of defining investment strategies - why must a firm define an investment strategy - should it not be carrying out its investment management service with a view to achieving its clients' objectives? - this may involve defining investment strategies, but the value of a specific legal requirement does not seem to us to be clear.

As a practical matter, we do not understand how any firm could demonstrate that any particular management activity had been exclusively motivated by the interests of clients. We consider that clients are well protected by all of the conduct of business provisions which are proposed to be imposed.

SUITABILITY

We support CESR in its approach to professional clients in relation to the issue of suitability.

Private equity firms deal with sophisticated clients who may, in MiFID terms, be retail clients (see our comments above). Such clients may on their own volition restrict the information



which they provide to the firm about their own circumstances. The advice must reflect the fact that the client also has a responsibility in relation to the provision of information to the firm. Particularly in the case of more sophisticated clients, it is important that it is recognised that the client will also have a role in deciding what information he wishes to provide. In such a circumstance, it is for the client to be satisfied that the information he provides is accurate and complete to the standard that he requires. To put the burden on the investment firm, particularly when it may be dealing with a client that does not wish to reveal the full extent of its finances, investments, etc., is unfair. A firm can only know what its client chooses to tell it. Indeed, there are many clients in some parts of the world who would regard it as exceptionally intrusive if they were to be pressed for information about their full financial situation. The guidance must recognise that not all investors are the same.

We are also not certain why, if a transaction is initiated by a client, the investment firm is obliged to check whether the financial instruments are suitable for the client. If a client on his own initiative instructs a private equity firm to make a particular transaction - it would seem an unfair burden on the firm to have to assess suitability. It may be that the firm should make it clear to the client that, in such a case, it is not assessing suitability - so that there is no mismatch of expectations.

We support CESR in its advice that a firm should not be required to obtain information on a professional client's knowledge and experience other than the information obtained to determine the client's professional status. However, as we have noted in previous submissions, due to the limited criteria for assessing professional status, there may be investors who are "professional" in a private equity context, who do not meet the criteria in the directive. It is for this reason that we consider, even where a client is not a professional client as defined in the directive, the information to be obtained from him and the duties owed to him still need to reflect his relative degree of sophistication. Again, we would emphasise the need for calibration in the advice to distinguish between different types of retail client.

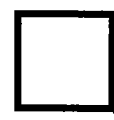
APPROPRIATENESS TEST

We support CESR in its opinion that information regarding the knowledge and experience of professional clients does not need to be requested. We would, however, repeat again that not only should there be a clear delineation between retail and professional clients, but there also needs to be a recognition that within the class of retail client there may, in relation to a particular service, be a range of sophistication across the persons who fall within the definition of "retail client". Thus, the second paragraph in box 9 should also refer to the sophistication and experience of the retail client and not only on the product envisaged and the service to be provided.

In addition it is not for the firm to be prejudiced if the client chooses to give inaccurate or incomplete information. Many clients are deliberately restrictive in the information that they provide about themselves - the guidance must not be drafted so as to assume that every client needs protection from its own inadequacies in the provision of information.

EXECUTION ONLY

We have raised in previous submissions a particular concern in relation to the execution only provision.



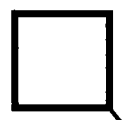
The concept of a non-complex instrument must recognise that whether or not an instrument is complex will in some circumstances depend on the nature of the person to whom the execution only service is provided. An execution only service in an unquoted investment to a present or former employee of a private equity firm (or indeed to an entrepreneur who has been backed by such a firm) may be in a non-complex instrument so far as that person is concerned. In determining criteria, therefore, CESR should allow account to be taken of the characteristics of the recipient of the service. The onus could be placed on the firm to be satisfied that, in any particular context, it is appropriate to classify the instrument as non-complex (thus continuing to protect the investor) - but the principle must allow for this.

In this regard, the definition of "non-complex instruments" in box 10 needs some significant change. A private equity investment is likely to meet the criteria in paragraph (b). It is irrelevant in the context to which we refer whether or not the information available is likely to be understood by the average retail client. The test should be whether the instrument is likely to be understood by the client to whom the service is promoted.

There is no reason why an instrument has to be frequently transferable or readily realisable in order for it to be non-complex. A share in a private company may be non-complex provided that the investor understands that it is not easily transferable or realisable - there is nothing particularly complex about the instrument itself. Its marketability alone is not an issue that makes it complicated.

Similarly it is not always the case that the unit in an unregulated scheme should be regarded as a complex instrument. Again, execution only services in units in private equity funds might be offered to executives in private equity firms and persons with similar experience without such an instrument being, in that context, complex. We have already mentioned the difficulties that are caused by the very wide definition of retail client and the need for calibration, flexibility and proportionality in the advice that is therefore given. It is essential that the advice on a non-complex instrument recognises that not all investors are the same, not all retail clients (within the MiFID definition) are the same and that what is complex must, in some circumstances have a relationship with the nature of the person to whom the execution only service is offered. We suggest that there be inserted in Box 10 after paragraph (c) a new paragraph as follows:

- “(c) and may also include a financial instrument
 - (i) that either meets the condition in (b) above, or whose maximum actual or potential liability for the client does not exceed an amount clearly accepted by the client; and
 - (ii) the characteristics of which the particular client may reasonably be expected to understand. In determining what a client may reasonably be expected to understand it may be appropriate for the firm to demonstrate that it has had regard to factors such as the client's employment, past experience with similar transactions, demonstrable knowledge and understanding of the key risk and other characteristics of the type of instrument concerned.”



ELIGIBLE COUNTERPARTIES

Question 6.1 - The quantitative thresholds for undertakings to request treatment as eligible counterparties should not be higher than the threshold for professional clients. As already noted, the threshold for professional client causes particular difficulties in the private equity context and we do not see why those difficulties should be exacerbated in relation to the eligible counterparty regime. Private equity firms should, if they are dealing with persons eligible to be professionals, who wish to be treated as eligible counterparties, be able to treat them as such.

CONCLUSION

We appreciate that CESR has a wide range of issues to consider, but we urge it to bear in mind the position of smaller, specialist firms when formulating its final advice on these important issues. We have focused in this response on those issues which we regard as of key significance to private equity firms. We have not made other more general comments which we believe are being made by other firms involved in investment management and investment advisory activities, in order to enable CESR to focus on the very particular issues that affect our industry.

As noted above we would be very happy to meet to discuss these points in more detail.

Yours sincerely



John Mackie
Chief Executive
British Venture Capital Association

