

18 February 2004

Mr Fabrice Demarigny  
Secretary General  
CESR  
11-13 Avenue de Friedland  
75008 Paris  
France

3 Clements Inn  
London WC2A 2AZ  
T 020-7025 2950  
F 020-7025 2951  
bvca@bvca.co.uk  
www.bvca.co.uk

Dear Mr Demarigny

**PROVISIONAL MANDATES UNDER THE FUTURE DIRECTIVE ON FINANCIAL INSTRUMENTS MARKETS (ISD2) - CALL FOR EVIDENCE**

The British Venture Capital Association is responding to the invitation to submit views as to what CESR should consider in its advice to the European Commission on the Financial Instruments Markets Directive. These comments particularly concern the Expert Group on Intermediaries Issues.

The British Venture Capital Association (BVCA) has around 165 members. This represents the vast majority of UK based private equity and venture capital firms. Those 165 firms are invested in over 11,000 companies, who between them employ nearly 3 million people. That is equivalent to some 18% of the private sector workforce. Our industry invests in every sector of the economy across all regions of the country. The UK accounts for some 40% of the whole of the European market and on the world stage we are second in size only to the United States.

The principal concern of the BVCA is that ISD2 is principally directed at activities on, and in relation to instruments traded on, regulated markets. ISD2, albeit at a high level, does not itself recognise that there are significant differences between unquoted investments which are not publicly traded and those which are dealt in on the capital markets.

The activities of venture capital firms relate to such unquoted investments. They may be advising on them, or managing discretionary portfolios. The procedure for making a venture capital investment is fundamentally different to that which is involved in dealing in investments on the capital markets. A transaction only takes place after detailed negotiation concerning all aspects of the entity to be acquired not just the quantity and price of its shares. This process can take a number of months, involve third party lawyers, accountants and due diligence sector experts and is only finalised after detailed agreements with the investee and others concerning the terms of the investment have been individually negotiated. An investment once made is likely to be held for a period of time - many years - before realisation.



In such a context many of the Conduct of Business rules which are appropriate and applicable to quoted investments make little sense. For example, an obligation of "timely execution" is difficult to construe in such a context; similarly, "best execution" is a more difficult context where there is no comparison point for the investment being made - each investment is unique, not only because of the company in which it is made, but also because of the detailed legal terms which relate to the security and the investment being made.

Our principal concern, therefore, is that the implementing measures for ISD2 must contain sufficient flexibility to recognise the difference between activities related to such investments and activities related to investments dealt in on the capital markets. This could be done by a definition relating to non-readily realisable investments, which would allow different rules to be made or for rules to be modified appropriately in relation to such investments.

In addition, we would note that the clients of venture capital firms are, generally speaking, institutional investors who negotiate the terms of the appointment of the venture capital firm with the benefit of their own legal advice.

We therefore support the statement that CESR should pay particular attention to the need to avoid formulation which would lead to over-prescriptive, excessively detailed legislation.

Particular areas where we have concerns include:

1. *Personal transactions*

CESR needs to be aware that many clients of venture capital firms require the managers responsible for their accounts to co-invest in transactions which are made for the account of the institution - because the institutions expect the managers to be prepared to back their own judgement. Whatever personal account transactions rules are recommended, we need to ensure that arrangements which are approved by the client are *prima facie* permitted (subject of course to overriding issues concerning insider dealing, market abuse - but these are not really relevant issues in the context of unquoted venture capital investment).

2. *Protection of clients' financial instruments*

As noted above, the investments with which venture capital firms are concerned are not traded on the regulated markets. A safe custody obligation undertaken by a venture capital firm will usually amount to the holding of a share certificate, the registered holder of which is either a nominee company or the client. The investment is essentially illiquid - because the investee articles will have significant restrictions on transfer (themselves imposed by the original investors). It is essential that whatever technical advice is given in relation to this issue, CESR takes account of the fact that some situations can be extremely simple and do not require excessively detailed conditions in order for the client's interests to be protected.



3. *Conflicts of interest*

Whatever recommendations are made in relation to conflicts of interest it is essential that they recognise that proper disclosure with informed consent is an effective way of dealing with conflicts of interest. Many venture capital firms operate on this basis of obtaining express investor consent to any issue which might give rise to a conflict.

4. *Conduct of Business obligations when providing investment services to clients*

For the reasons given above we think it is essential that CESR does recommend proportionate and appropriate provisions. In the context of venture capital investment it is essential that it is recognised as involving different financial instruments and different services to those involved in services related to normal capital markets instruments.

Thus, for example, the nature of the warnings that have to be given is entirely different in an unquoted scenario.

The rules for reports from a firm to its clients also need to take account of the fact that, where the client has agreed (or required) the provision of information in a particular format, then this should be sufficient. Due to the fact that venture capital firm clients negotiate the basis on which they appoint the venture capital firm, these clients (who are often outside the EU) have their own detailed stipulations as to the manner and form of reporting and the timing of reports, to suit their own particular needs. Many investors stipulate that reports to them must be prepared in accordance with the published BVCA guidelines. It is essential, therefore, that the recommendations concerning reports from a firm to its clients do not result in duplication and excessive bureaucracy for firms which have agreed such arrangements.


5. As noted above, the best execution policy and order execution policy are particularly difficult to apply in the context of venture capital investments. There are no trading venues, the concept of an order execution policy is inappropriate, issues of the likelihood of execution and settlement and speed are irrelevant, as are those related to size and nature of the order.

6. Venture capital firms are often small in terms of the number of personnel employed. The concept that there would be detailed organisational requirements requiring, for example, segregated accounting functions and the like, may be simply impossible to incorporate into a firm which has perhaps seven to eight executives and three or four support staff. It is essential that the obligations and procedural requirements which are laid down recognise that not all firms are major institutions and that not all controls that are suitable for certain types of business are suitable for all types of business.



We would welcome discussing these issues with you in more detail if that would be helpful.

Yours sincerely

A handwritten signature in black ink, appearing to read 'John Mackie'.

John Mackie  
Chief Executive

cc: Clive Maxwell, HM Treasury  
Neil Barnes, HM Treasury  
Enam Ahmed, HM Treasury  
Richard Price, Enterprise Team, HM Treasury

