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The Committee of European Securities Regulators
via CESR's website: www.cesr-eu.org

Ladies and Gentlemen

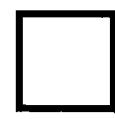
CESR's Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments - 1st Set of Mandates - Second Consultation Paper

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 response dated 17 September 2004 to the first CESR consultation paper on the first set of mandates.

As discussed in our previous response, the BVCA expects that most comments received by CESR will relate to the implications of its advice for activities relating to marketable securities. However, private equity investments, being illiquid, raise fundamentally different issues to those raised by marketable securities. The BVCA considers that the sections in the consultation paper concerning the independence of compliance, conflicts of interest, the outsourcing of investment services and transitional issues raise particular issues for private equity and venture capital firms and these are considered further below.

General questions from the first consultation

We welcome CESR's recognition that in the finalisation of its advice there will be an assessment on a case by case basis to strike the right balance between different interests and to address various differentiations in the market. In the case of private equity, it will be seen from all of our comments,



that there is a balance to be struck. The issues which arise for and in respect of private equity firms are significantly different to those which arise for more traditional investment firms. A failure to recognise this in the final advice could have serious implications for the operation and provision of private equity across Europe.

Lack of responses from consumers and retail investors

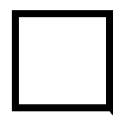
We note and understand CESR's concern about the low level of input from consumers and agree that it should take this into account in its final calibration. However, CESR needs to take this into account only where it is relevant. Private equity firms do not tend to deal with retail clients and the needs of consumers and retail investors should not be taken into account in circumstances where they are not particularly relevant.

Transitional issues

CESR seeks practical and concrete exemplification of the difficulties envisaged by market participants in the implementation of the new proposed advice. In particular CESR wishes to receive information on the timing of what is practicable in terms of systems changes needed to implement these proposals.

As discussed above, and in our previous response, many of the changes proposed by CESR are likely to have a significant impact on the business of investment firms; such firms are therefore likely to face difficulties in implementing such changes, including managing related costs, without the benefit of a transitional period. For example, firms would require some time in order to effect changes to their client agreements. Private equity firms do not operate on the basis of standard terms of business, each mandate is separately negotiated with clients who are in a position of considerable negotiating power. Changes to the contractual arrangements will necessarily take some considerable time.

CESR will note from our comments below that we have significant concerns about any proposal for mandatory outsourcing of compliance. Firms forced to outsource compliance would face considerable disruption and difficulty in sourcing adequate and competent suppliers, all with the attendant risk that this would cause. We very much hope that CESR does not mandate the outsourcing of compliance - but if it did there would need to be a transitional period during which a firm could retain its existing arrangements, in order to avoid the risks we highlight below. A requirement for small firms to outsource the compliance function would require a market for such outsourcing to be developed and for structural changes to be made to the management of compliance within firms; firms would clearly face significant difficulties in achieving this without the benefit of a transitional period.



Independence of Compliance

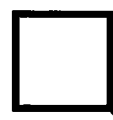
Consultees are invited to express their views on the proposed approach and in particular their opinions on the last option, with concrete proposals on the best way to achieve the objective of independence of compliance other than by compulsory outsourcing of the function in case of very small firms. Consultees are also invited to provide criteria to clearly define these small firms.

The BVCA agrees that the fundamental requirement for all investment firms should be the establishment and maintenance of an effective compliance function. Although it is not entirely clear what a "functional" as opposed to an "organisational" approach to this issue would involve, the BVCA welcomes the view that the "four eyes" approach might not be practicable for small firms and agrees that other options for ensuring that such firms have an effective compliance function should be considered.

As we have stressed before the key issue is that compliance is effective. We believe that effective compliance requires general awareness within a firm of compliance issues and a willingness to deal with them. This means that compliance needs to be built in at all aspects of a firm's business and not be seen as a "add on". In developing and providing products and services there needs, at the time of development and provision, to be compliance foresight and awareness. Compliance is not an exercise to be carried out in isolation from an understanding of the way in which a business is conducted, nor is it at its most effective when it is conducted "after the event". Whilst there must always be compliance monitoring which is of an "after the event" nature, this is not the only or primary function of compliance. We feel very strongly indeed that mandatory outsourcing of a compliance function is the least desirable alternative, and our views on this matter are formed as a result of direct experience of outsourced compliance services.

Option (ii) - alternative systems and means for effective compliance

Of the two options presented as alternatives to the "four eyes" approach, the BVCA therefore strongly prefers option (ii); in our view, this is the most workable option for small firms including private equity and venture capital firms and we have actual experience of its effectiveness. As explained in our previous response, alternative systems and means for ensuring effective compliance in small firms should be based upon the direct regulation of the person responsible for a firm's compliance function by the competent authority. Specific requirements could be imposed in order to support and increase the effectiveness of direct regulation e.g. such a person should be of appropriate seniority within the firm and should be personally responsible for reporting on compliance issues to those responsible for the on-going management of the firm.



In our experience, the direct regulation of senior in-house compliance officers by the competent authority, reinforced by the potential for sanctions to be imposed on those officers in the event of breach of duty, is the most appropriate means of achieving the objective of an independent compliance function. We believe that since the UK adopted this approach there has been a marked impact on the attitude with which firms of all sizes take to compliance issues. Furthermore, in-house compliance officers increase the effectiveness of the compliance function as they are usually involved in the compliance aspects of the business on an on-going, day-to-day, basis and are able to use their detailed knowledge of the business in order to manage more effectively the firm's compliance function.

Option (i) - outsourcing the compliance function

In our view, option (i), the outsourcing of the compliance function, would be the least practicable option for ensuring an effective function. A mandatory outsourcing carries, in our view, the risk of giving a false comfort for the following reasons, which are based on our members direct experience of outsourcing compliance issues:

- an outsourced function becomes, almost by definition, a retrospective 'box-ticking' function. A compliance function which does not operate within a business has little hope of being aware of and dealing with issues before they become problems. The outsourcing of the compliance function imposes distance between it and the business of the firm and results in a less effective and useful function. An effective compliance function, in contrast, requires a permanent presence within the firm, familiar with the business being conducted, able to pre-empt issues - avoid problems and failures, rather than detect them after the event. An in-house compliance officer will have a detailed knowledge of the firm and its business and is therefore likely to be particularly effective in carrying on the compliance function. In our experience, for example, each private equity transaction raises different issues and take a considerable period to negotiate, during which issues may arise which require immediate on-site opinion and action. The retrospective consideration of the transaction by an external compliance consultant is unlikely to be useful or relevant. Indeed, in many cases he will not have the expertise to know where problems might be, simply because he does not have an appropriate understanding of the business;
- the lack of a market for outsourcing of the compliance function would be an obstacle and the market is currently of uneven quality and depth. For example, in the private equity context, most if not all of the possible candidates for such a function are already involved within private equity firms in a compliance role. Even if a market were to develop, it would be likely to

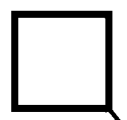
consist of a small pool of compliance consultants who would service the compliance requirements of a number of competitor firms; for commercial and confidentiality reasons, firms may not be comfortable with appointing such consultants. Furthermore, there are likely to be increased costs involved in the outsourcing of the compliance function, which are not, for the reasons given, counterbalanced by an increase in effectiveness.

- there are liability issues - there is no requirement for such persons to carry insurance and we believe that many do not have any cover, or have only minimal cover. Almost all seek to place significant contractual limits on their liability.
- outsourcing a function means it is less likely to have the ear of senior management, to be aware of stresses and tension within the business - all of which reduces its effectiveness.
- CESR may also wish to consider the extent to which a compliance consultant who is chosen, remunerated and monitored by an investment firm would be independent of that firm. It is arguable that the direct regulation by the competent authority of a compliance officer of appropriate seniority would achieve more or at least the same degree of independence as an external compliance consultant and without sacrificing the benefits of the day-to-day involvement of the compliance function.

In the event that CESR concludes that outsourcing of compliance should be required, it would be helpful if further guidance were provided as to how firms would oversee the outsourced function. (The BVCA assumes that firms would remain ultimately responsible for the compliance function; to conclude otherwise is unlikely to be inconsistent with existing policies and rules of competent authorities and CESR's approach, for example, to the outsourcing of investment services). In our view, for the same reasons as discussed above, a firm's oversight of compliance will be less effective where the function is outsourced as opposed to carried on in-house.

Small firms

We would strongly encourage CESR to avoid defining "small firm" - any definition would be incapable of reflecting myriad business structures. The issue is not size per se - the real issue, as recognised by the existing CESR standard, is determining what is appropriate and proportionate in view of the complexity of the business of the firm and nature and scale of the business. It is therefore an issue which requires determination in the light of the circumstances of the firm and cannot be solely determined by a solution based on, for example, number of personnel.



Take for example a private equity firm. Some firms have only two executives and one secretary - clearly small. Others may be larger in terms of the number of personnel - but nevertheless the number of transactions which are executed in any year may be very few. Some of the staff employed by the firm will be used in connection with the monitoring of existing investments, in searching out and negotiating transactions which may not come to fruition. The compliance issues that arise in a venture capital firm are much simpler than those which arise in other businesses - for example there are no markets on which dealings take place, issues such as best execution, timely execution, aggregation of transactions, execution venues are not as complex as those which arise in other contexts. Moreover the third party clients are professionals.

It is for this reason that we urge CESR not to limit the options to "small firms", particularly if this concept is narrowly defined. The issue should be one for a firm (and its regulator), depending on what is proportionate.

In particular, direct regulation of the person responsible for compliance may provide the best solution in many cases. In this respect we do not agree that the option is for the firm alone to show alternative systems and means to ensure effective compliance. The entire structure within which the firm operates would, if it involved direct regulation of the compliance officer, provide an external effective means of achieving this.

This issue is key to our constituency. Our views are not formed in the abstract, but are based on direct experience, both of outsourcing compliance and of the impact of having a regulated compliance function.

Conflicts of Interest and the Segregation of Areas of Business

Consultees are asked to express their views on the proposed approach.

The BVCA welcomes the second, more flexible, approach to the management of conflicts of interest and generally agrees with the principles put forward by CESR in this section of the consultation paper. The BVCA agrees that firms should be given discretion as to the means, systems and controls employed to prevent or manage conflicts of interest and that there should be clarity as to their use.

However, we consider that an important distinction should be drawn between the different objectives of (i) preventing and (ii) managing conflicts of interest. In our view, it is not always appropriate to prevent conflicts of interest, particularly where clients provide their informed consent. For example, in the private equity context, clients regularly consent to and indeed require co-investment by the



private equity firm managing the relevant transaction. In these circumstances, firms should only be required to establish and maintain systems and controls in order to manage identified conflicts of interest.

We are not sure that we understand the comment that information barriers, such as Chinese walls, should not be mandatory, "but other means should be at least as effective". A properly working Chinese wall prevents the dissemination of information between different areas of a business. This is one way of managing a potential or actual conflict. Other ways involve obtaining the consent of clients - this does not produce the same effect as an information barrier - but it does prevent the firm from breaching its fiduciary obligations. More clarity is therefore needed in respect of this particular point.

Outsourcing of investment services

Consultees are invited to express their views on the proposed approach.

As discussed in our previous response, we strongly recommend that the CESR Standard 127 should not be retained or extended and recommend that the responsibility for outsourcing be placed on the outsourcing firm. It should be for the investment firm to justify the use of any third party, particularly unregulated third parties. To retain and/or extend the CESR Standard 127 could, in the private equity context, have an adverse impact on client interests. As we have already noted, private equity investment management activities are not regulated in many countries where there is considerable private equity expertise. The proposal would prevent outsourcing in a private equity context to a third party who is best qualified to undertake such management but whose activities are not regulated e.g. a U.S. based private equity portfolio manager. Furthermore, we do not consider it appropriate to apply the provisions of the UCITS Directive, which concerns publicly marketed authorised funds, to all investment firms regardless of the type of business they undertake.

Parity with the UCITS Directive is simply not appropriate for managers who invest in private equity situations and whose clients are professional investors. There is no reason why they should be put in a position where they are restrained by the same rules that apply to funds marketed to the general public and which invest in the liquid markets. Such a requirement would operate to the disadvantage of clients as it would prevent any outsourcing to firms best placed to provide the necessary service. The responsibility for the outsourcing should remain that of the investment firm.

The BVCA member firms may be one of the "few exceptions" referred to in the CESR commentary on this issue. The reason we are an exception, is because the needs of private equity firms are



different. It is essential that this difference is recognised by CESR, if private equity is to continue to flourish across the European Union.

We hope CESR finds the above comments helpful. If CESR requires further information please contact me on +44 207 025 2960.

Yours faithfully

A handwritten signature in black ink, appearing to read "pp Lane Black".

John Mackie
Chief Executive

