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Dear Sirs

Re. FRC Consultation: Auditing and ethical standards - Implementation of the EU Audit Directive and Audit Regulation

The British Private Equity and Venture Capital Association ("BVCA") is the industry body for the private equity and venture capital industry in the UK. With a membership of over 500 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. This submission has been prepared by the BVCA's Legal & Technical Committee, which represents the interests of BVCA members in legal, accounting and technical matters relevant to the private equity and venture capital industry.

Our members have invested £30 billion in over 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 790,000 people and almost 90% of UK investments in 2013 were directed at small and medium-sized businesses. As major investors in private companies, and some public companies, our members have an interest in reporting matters, the conduct and information presented by such companies, and the burdens placed on the management of such companies.

We support the objective of seeking to increase quality and independence in the audit market, but we do have a number of concerns with the extent of some of the suggestions in the Consultation, especially in the context of the potential impact on choice of accounting firms to provide services. Given how many people are likely to comment on the Consultation, we have limited our responses to those questions that we believe are of particular relevance to our members. We have attached these points to questions 4 through 10 of the Consultation, however, our concerns are at a more general level.

Background to Private Equity and Venture Capital

Private equity and venture capital firms are long-term investors, typically investing in companies for around 5-7 years. This means a commitment to building lasting and sustainable value in the businesses they invest in. Typically firms will sell their stake in a company by listing on the public markets or selling to a strategic buyer.

Private equity and venture capital firms raise capital to invest from sources such as pension funds, endowments, insurance companies, banks, family offices/high net worth individuals and sovereign wealth funds.

A private equity or venture capital manager manages one or more funds, often set up as limited partnerships. The funds are closed-ended meaning that they have a limited life span, the industry standard being 10 years. The funds will invest in companies in the earlier part of a fund's life until an agreed date (e.g. 5 to 6 years) and exit investments in the run up to the fund's tenth anniversary. The life span of a fund can be extended (if permitted in the fund's constitutional agreement) and this is typically up to 2 additional years.

Private equity and venture capital managers operating in the UK will be authorised and regulated by the Financial Conduct Authority ("FCA") and now (for funds which are in-scope Alternative Investment Funds ("AIFs")) must be authorised and regulated by the FCA as an Alternative Investment Fund Manager.

Questions 4 – 6: Extending the more stringent requirements for Public Interest Entities ("PIEs") to other entities

We are extremely concerned at the possibility, by implementing the restrictions on non-audit services required by the Regulation through the Ethical Standards to a broadened definition of "Listed Entities" and to "affiliates" of such entities, of extending the requirements in the Regulation to as wide a group of entities as suggested by the Consultation. We believe that this extension would amount to gold-plating of the UK's implementation of the Directive and Regulation. Rather, we see this as an opportunity to revisit the scope of the current Ethical Standards to consider whether they are catching a wider population of entities than was really the intent.

Our concerns focus first on the potential restrictions on choice and quality of service provider that could flow from the suggested widening of the scope of the Regulation. These concerns arise due to, and are compounded by, the transaction-driven nature of our industry and management of controlling stakes in investee or portfolio companies through fund structures. This is very different to typical corporate group structures and there is considerable complexity involved in analysing audit and adviser relationships, also noting that this extends beyond the 'Big 4'. Our interest in the Regulation was driven by the initial proposal to include AIFs in the definition of a PIE, a proposal which would have been disruptive and likely led to additional costs for investors. Despite AIFs being removed from the EU definition of a PIE, our members will still need to review the implications of the Directive and Regulation. We should also note that some funds will have investments in companies that meet the definition of a PIE and so will have to consider the impact of and comply with the restrictions. Alongside concerns about choice of providers, many of the companies and firms that could be impacted are likely to be SMEs. Therefore the burden placed on these firms will be disproportionate and whether these are public interest entities in a more general sense ought to be considered.

Secondly, we are concerned that any departure from the requirements of the Regulation is almost certain to create inconsistency in how the rules work between Member States, which will just add to the complexity for companies and their directors in a world where so many groups have cross-border considerations (for example, companies incorporated in one country but with securities listed in another). We believe that everything possible should be done to achieve consistency in application of the Directive and Regulation between Member States rather than doing things which are almost bound to result in the opposite effect.

Relevance of listed securities to the private equity and venture capital industry

Listed securities are relevant to the private equity and venture capital industry in a number of ways. There are a few private equity houses that are themselves part of a listed group or are listed private equity investment trusts or venture capital trusts. They clearly come within the scope of the Regulation. However, for the majority of houses, the potential impact of the Regulation comes from listed securities within their investee or portfolio companies. Such securities can take various forms, the key examples being:

- Equity shares in the portfolio company are listed – this may be because (a) the private equity house has undertaken a 'public to private' transaction to acquire a listed company and either has not acquired the 90% required to compulsorily purchase (i.e. 'squeeze out') the minority but has nevertheless declared the offer unconditional such that a listed minority remain, or has acquired more than the required 90% but has not yet completed the legal process to squeeze out the minority and hence has a temporary position of having a portfolio company that still has listed shares (the particular issue of having this temporary situation is considered later in this letter); or (b) the private equity house has undertaken a partial exit through IPO of its investment such that it is then in a position of having a stake in what is then a listed company;

- The portfolio company has issued high yield bonds (being bonds with a lower credit rating than investment grade bonds and which therefore have a higher yield to reflect the higher risk of default), which are typically listed on the Luxembourg Euro MTF or the Irish GEM exchanges, both of which are 'recognised' but not 'regulated' markets;

- The private equity sponsor has provided funding through interest bearing loans (often referred to as shareholder loans), which are commonly listed on a stock exchange recognised by HMRC, in particular the Channel Islands Securities Exchange ("CISE"), but which are in fact not traded as the loans are held entirely by the private equity fund. Again, the CISE is a 'recognised' but not 'regulated' market.

Our concerns relate to the latter two situations, which involve debt listed on non-regulated markets, most of which are in Luxembourg, Ireland and the Channel Islands, and which are extremely common in private equity. The use of the CISE has grown in recent years as portfolio companies can benefit from HMRC's Quoted Eurobond Exemption ("QEE"), a policy which helps to attract international investors to the UK by allowing them to pay tax only once on their investment. When capital flows back to investors, some are subject to tax and some, such as pension funds, are exempt. The QEE allows international investors to commit capital to funds and in turn into UK companies, thus only paying tax where it is due. The alternative is for HMRC to apply a 20% withholding tax on these investors and for them to claim it back – imposing a significant administrative burden, delay and thus cost, thereby reducing returns to pension funds and with no gain to the Exchequer.

Definition of PIE vs Listed Entity

The Consultation refers to the contrast between the definition of a PIE in the Directive and that of a 'listed entity' as used by the FRC. That definition is stated to be (paragraph 3.9):

"Listed entity – An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body."

The first point to make is this is not an accurate reproduction of the definition in the Ethical Standards (we believe it comes from the Auditing Standards), which in fact state as the definition *"An entity whose shares, stock or debt are quoted or listed on a **UK or Irish** recognised stock exchange, or are marketed under the regulations of a **UK or Irish** recognised stock exchange or other equivalent body."* (emphasis added).

The exclusion of the words "UK or Irish" has significance for private equity and venture capital, given the prevalence of debt securities listed in Luxembourg.

However, we actually believe that the issue is wider, as the actual Ethical Standards definition still captures a large number of entities within the industry which are not what we believe the Ethical Standards were intending to catch. The definition in the Ethical Standards goes on to state *"This includes any company in which **the public** can **trade shares** on the **open market**, such as those listed on the London Stock Exchange (including those admitted to trade on the Alternative Investments Market), PLUS Markets and the Irish Stock Exchange (including those admitted to trade on the Irish Enterprise Exchange)."* (emphasis added).

While acknowledging from the word "includes" that this is only an example, the words in bold can be contrasted with both high yield bonds and shareholder loans:

- These debt instruments are not investments held by "the public";
- In the case of shareholder loans, they are not "traded";
- They are not "shares"; and
- The relevant markets are not "open" but are used solely by sophisticated investors.

This demonstrates to us that the current Ethical Standards definition catches a wider group of entities than was the focus of the APB / FRC in developing them.

We fully understand that there is a benefit in, if possible, avoiding a situation where different restrictions within the Ethical Standards apply to different types of entity. That would be simpler for companies, their directors, audit committees and accounting firms.

However, we believe that, for the reasons explained below, this should be achieved by changing, to the maximum extent you consider acceptable in the context of the public interest, the definition of Listed Entity used in Ethical Standards to conform with that of PIEs in the Directive so that, if possible, you have one definition of "Relevant Entities" to which the Ethical Standards apply. This would exclude from the restrictions on non-audit services in the Ethical Standards those companies that solely have listed debt such as high yield bonds and shareholder loans which are held either only by the private equity house itself or by sophisticated investors, where we do not believe that there is the public interest in the way contemplated in the Ethical Standards. This would address the key concerns of BVCA members as described below.

We would recognise that you may be concerned with the potential implication of this for companies with shares traded on AIM or with listed investment grade debt in which the public invests. However, given that these companies are of less relevance to BVCA members, we do not make suggestions as to how you might address these companies, but would understand if you were to treat them differently. For our members, the critical factor is that we do not believe that the companies with the kind of listed debt that is prevalent in private equity and venture capital should be caught by the restrictions in the Ethical Standards as widened by implementation of the further restrictions coming through from the Regulation.

Implications of a wider definition

If the existing "Listed entity" definition in Ethical Standards is widened to include everything within the Directive definition of PIEs, or (even worse) made wider still by removing the words "UK or Irish", and then the restrictions on non-audit services from the Regulation are then applied to all such entities, there are significant potential issues for the private equity and venture capital industry.

First and foremost, there is a potential significant restriction in choice available to the private equity house regarding using accounting firms to provide services. This arises from the fact that, by contrast to a corporate group which more often than not (and probably even more so going forward) will use one firm for the audit of all its group companies, private equity structures (i.e. the house/manager, fund(s) and its portfolio companies) do not operate in the same way. In particular, many private equity houses do not see it as their role to intervene in portfolio company management's decision as to what firm to use as auditors. Hence it will often be the case that many different firms audit different portfolio companies. As a result, if the definition of companies to which the Regulation restrictions on non-audit services apply is widened, it would be common for a house to have several portfolio companies that are each Listed entities and audited by different firms, with the house then potentially being restricted in using any of these firms for services that it itself is looking to procure, for example, in relation to making new investments. This would be particularly the case if the net of which other entities are tainted by a

PIE/Listed entity is based on the concept of an "affiliate" as used in Ethical Standards rather than that of "parent undertaking" used in the Directive (this is another area which we believe the FRC should consider carefully, as it has the potential to make the restrictions in the Regulation applicable to a much wider group of entities than required by the Directive). This restriction on choice is a significant issue for the private equity house as it conflicts with another fundamental point for a private equity or venture capital fund manager, being their obligation to seek support and advice from the most relevant and appropriately experienced advisors. Something that could restrict their choice as to who is most appropriate to provide that support and advice would be a major concern to them.

Other relevant factors are:

- Depending on precisely how the Directive definition of PIEs is incorporated into the Ethical Standards, if portfolio companies were to come within the definition of entities to which the restrictions in the Ethical Standards, as expanded for the requirements of the Regulation, apply, a potential means for the private equity house to escape potential restrictions on services that it could procure from a firm that audited a restricted portfolio company would be for the relevant private equity house entity procuring services to be outside the EU. It would seem contrary to other public interest perspectives to introduce restrictions that incentivise organisations to move activities offshore.

- Alternatively, the private equity house could seek to rely on technical arguments to conclude that it is not a “parent undertaking” of the portfolio company (although this would be again impacted by the “affiliate”/”parent undertaking” point referred to above). We believe that our members would much prefer clarity that they are outside the scope of the Ethical Standards / Regulation than rely on such arguments to overcome a lack of choice as to who they can use.

- It is very difficult to see how the cap for fees for non-audit services would operate, and result in a meaningful answer, in a private equity structure. For example, a firm may have relatively low audit fees for a comparatively small restricted portfolio company. To compare these fees with those for non-audit services to the private equity house relating to other portfolio companies that may be many times larger than the restricted portfolio company causing the problem may produce totally anomalous results and not ones relevant to what the fee cap is seeking to address. Furthermore, calculating the fee cap requires the communication of information among members in the private equity structure. By contrast to a corporate group, this is much more problematic and complex in a private equity situation. In some instances there are legal restrictions coming from confidentiality agreements relating to other investments being made by the private equity house, but even where there are not, many private equity houses would not explain to their portfolio companies other things they are doing that do not relate to that business. Hence, for the portfolio company that is restricted, there would be significant practical issues in them ensuring compliance with any fee cap.

Conclusion

We therefore are strongly opposed to any move that would bring private equity portfolio companies with listed debt, other than potentially those very rare cases where it is investment grade debt that could be held by the public, within the definition of entities to which the restrictions on non-audit services in the Regulation apply. Indeed we believe that the current Ethical Standards definition should be refined so far as is considered possible within the implications of the public interest so that it aligns with that for PIEs in the Directive and so that it captures what we believe it was intended to cover. Furthermore, we believe that the implications of what other entities are tainted should be addressed so that it is only those entities that are parent undertakings or controlled undertakings, as per the Directive, that are caught, not any wider principle based on "affiliates".

We believe that a solution can and should be found that protects non-professional investors investing in regulated markets, which is where the "public interest" lies and which we believe is the objective of the Regulation, without extending that out to a wider group of companies where the restrictions on choice and other implications do not produce a commensurate benefit.

Resolving the question of the entities to which the restrictions in the Regulation apply and which other entities are tainted addresses our principal concerns from a private equity and venture capital perspective; however, there are further points which we consider below.

Question 8: Prohibited Non-audit Services - Due Diligence

Given the fact that the private equity and venture capital industry is based on transactions, due diligence is a critical service. We believe this should be clarified as a permitted service. Our concerns again centre around choice and the quality of service available to the private equity house in this service which is key to protecting stakeholders and investors in the fund.

Even if the PIE definition is addressed as advocated above, there will still be situations where private equity houses are subject to restrictions on non-audit services they can procure from accounting firms. We believe due diligence should be made clear as a permitted service, whether this be via a black list or a white list. We note that the provision of due diligence is referenced as an example of permissible services in paragraph 8 of the preamble to the Regulation and the European Commission's Q&A published in September 2014, but this is not made clear in the actual Regulation, so this uncertainty should be clarified. This seems to us wholly understandable as we do not see it as a service conflicting with an auditor's independence, but rather requiring the production of an independent view on a business and its financial information, using the same values of independence and objectivity that you would expect of an auditor. The lack of choice that would otherwise arise is that regulatory restrictions are not the only consideration in deciding who should undertake due diligence. For example, some private equity houses have a policy of not using the accounting firm that audits the target business to undertake due diligence; some also have a policy of not using a firm that has undertaken vendor due diligence commissioned by the vendor or target. Hence, other considerations can rule other accounting firms offside for doing the buy-side due diligence. Imposing another restriction, which we do not believe is necessary, to rule out one or more further firms (especially if restrictions were flowing up from multiple portfolio companies to mean that more than one firm was restricted) could dramatically reduce the choice of which accounting firm could be used.

Furthermore, a regular approach to driving growth in portfolio companies is through the making of bolt-on acquisitions. Whilst such acquisitions are typically initiated by the private equity house, it is the portfolio company that actually commissions any advisor services. It would be an unfortunate restriction of choice to prohibit the firm that had undertaken due diligence on the original portfolio company acquisition from undertaking due diligence on a proposed bolt-on because it was the auditor of that portfolio company in situations where that portfolio company was or had become an entity to which the restrictions in the Ethical Standards apply. Alternatively, it would seem a similarly unfortunate consequence to require the portfolio company to change its auditor to avoid such restrictions.

It should also be recognised that making due diligence a prohibited service would encourage a move towards private equity houses requiring portfolio companies to change auditors so as to concentrate the related restrictions on one firm so as to preserve the maximum choice of providers for other services. We do not believe that this would be healthy regarding competition to provide the audit services, and also interferes with the principle that exists in many houses that choice of auditors is a matter for portfolio company management, not for the house.

Question 10: Prohibited Non-audit Services - Tax advisory services

While the provision of several tax services is specifically prohibited under the Regulation, Article 5 of the Regulation provides the option for Member States to permit certain of these services, provided they have either no direct or only an immaterial effect on the relevant financial statements and where the estimation of the effect of the services is documented as part of the auditor's additional report to the audit committee. We believe this Member State option should be taken up.

Tax structuring advice is a critical service for private equity and venture capital in order to maximise potential returns for the institutional investors in the fund, especially given the complexity of fund structures and many of the transactions private equity houses undertake.

As explained earlier, the restrictions coming from the Regulation will nearly always come from a portfolio company that is restricted rather than from the private equity house itself. However, the tax advice is typically at the private equity house level, either for itself (e.g. its fund structure, etc) or in relation to making other investments. Hence the implications of the tax advice in most cases don't have any impact on the financial statements of the restricted entity and we don't see that there is a material risk to the independence of the auditor of the relevant portfolio company.

There is significant benefit in continuity of advice in relation to tax matters. For another adviser to step in and understand all the angles is often extremely difficult and that is when mistakes occur. Taking this Member State option is very important for the industry to minimise the situations where the private equity house has to either change tax advisers for its own affairs or impose a change in auditors on its portfolio company.

Other: Transitional arrangements and temporary changes in Listed Entity status

Non-permitted non-audit services are prohibited for the whole of the period from the start of the accounting year for which the audited accounts will be prepared until the filing of those audited accounts. In addition, services advising on accounting, internal control and risk management systems at the audited entity are also prohibited for the year before that for which the audited accounts are prepared. These prohibitions apply to the PIE itself and also to its parent and subsidiary undertakings within the EU.

We are concerned regarding the implications of this in transitional situations around the time of a transaction. The more some of the points we make above are addressed, the fewer the number of situations that will arise where there is a result that seems unnecessarily disruptive. However, the problems will not be eliminated entirely without being specifically addressed. For example:

- A private equity house makes an offer for a listed company and secures over 90% acceptances, at which point it declares the offer unconditional. It then implements a process to squeeze out the minority but which takes time (perhaps 6 months) to complete. Depending on the precise facts, the private equity house could be the parent undertaking of what would be a Listed entity (and hence an entity to which the widened restrictions in the Ethical Standards coming from the Regulation would apply) for the period from when the offer is declared unconditional until the squeeze out is completed (at which point the portfolio company would cease to have any listed shares and hence would cease to be a Listed entity). Hence, there would be an issue if the private equity house were obtaining non-permitted services from the accounting firm that audits the Listed entity during that transitional period when the portfolio company was controlled but still listed. Suspending or transferring the service to another provider would be a very unfortunate requirement.

- A portfolio company becomes a Listed entity (especially if our first point above is not accepted and the issue of listed debt makes it a Listed entity) and the private equity house has non-permitted services in progress from the accounting firm that audits the relevant portfolio company.

We believe that where it is within the FRC's remit, for example if the UK opts to go beyond the Regulation in its implementation, further consideration is desirable on transitional provisions that could be put into place. This could probably be subject to some time limit and cover services that are in flight but for whatever reason become restricted. This would particularly be the case where those services have no relevance to the financial statements of the actual Listed entity. Changing provider mid-way through a project is disruptive and invariably results in additional cost. We believe that, if at all possible, there need to be transitional or 'grandfathering' provisions to minimise the incidence of such situations.

Consortia deals

Particularly for larger transactions or in certain sectors such as infrastructure, it is common for private equity houses to team up as the transaction is too large for any one house. This introduces an additional complexity into the question of which accounting firms are available to do any work that is required as, without clarity as to how the rules operate, restrictions could come up from each member of the consortium, leaving little or no choice as to which firm can be used. This is especially the case as this situation most commonly applies on larger transactions which are invariably multi-territory and hence require the resources and expertise of the larger firms.

We believe that it should be made clear that the only restrictions that should apply are those applicable to the house that controls the consortium (if any – often it will be none, as they are operating on a consensus basis without anyone having control to force anything through). This seems to us entirely logical and consistent with the Regulation as, once the point in the transaction is reached at which a new company is formed to implement the transaction, that company would be restricted under the rules in the Directive and Regulation only by a PIE that controlled it and was its parent undertaking. It would therefore seem illogical to us for non-audit services that could be provided to the new company once formed to be restricted in the period when it does not yet exist and hence it is the consortium members engaging the accounting firm. However, we believe that there should be clarity that this is how the rules operate.

This would also address the very common situation where there is initially one private equity house looking at a transaction and engaging advisors, but where one or more additional houses are then brought in. It would be very rare for such additional houses to come in and be in a controlling situation. However, it would be extraordinarily disruptive or restrictive on what houses could join in if restrictions coming from that additional party meant that the firm already providing advice suddenly found that it was subject to restrictions coming from the new party and had to be replaced. Provided that it is clear that restrictions come only from a controlling party, that situation would not arise.

The BVCA would of course be willing to discuss this submission with you further and, if you so wish, please feel free to contact me.

Yours faithfully

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