The UK Regulatory Environment for Funds and Private Equity Firms

London

BACKGROUND TO PRIVATE EQUITY REGULATION

For many years private equity advisers in the United Kingdom were at the fringes of regulation. They had only dealt with sophisticated customers in the guise of the general partners of the private equity funds they advised and their regulated activities were confined to the provision of investment advice and arranging deals. Whilst the scope of their activities has not changed significantly, the regulatory environment in which they operate has.

The philosophy of regulation in the United Kingdom has moved over time from a prescriptive approach to an approach that is based more on principles, with the focus on outcomes. Such a philosophy has latterly reduced significantly the number and volume of rules and regulations governing financial services businesses in the United Kingdom. Though at first glance less may seem indeed to be less, less can actually mean more, given the general nature of the obligations, the reluctance of the regulator to provide guidance on what those obligations mean in practice, and the nuances and complexities of the particular regulated business.

What that means for private equity advisers is that a more holistic approach to compliance and regulation needs to be taken where operational risk plays an increasingly significant role. The growth of the private equity industry has not only raised the game on the investment side, but also has led to the perception that closer and deeper regulatory controls are required — as can be seen most recently in the form of the Alternative Investment Fund Managers Directive ("AIFMD"), discussed further below. In addition, building stakes in listed companies requires knowledge and consideration of many more legal and regulatory matters than is the case in a small venture capital financing.

Here we consider the content and framework of Financial Services Authority ("FSA") regulation of a private equity adviser operating from the United Kingdom. The emphasis is on regulation, but this briefing also considers the key issues to consider in stakebuilding.

INTRODUCTION TO UK REGULATION

Private equity firms in the UK, and the funds that they manage, are broadly subject to two types of legislation. The first, affecting funds and firms alike, is to be found in and under the Financial Services and Markets Act 2000 (the "FSMA"). The second, affecting firms only, will depend on the structure that the firm adopts. If it is established as a limited liability partnership ("LLP"), the Limited Liability Partnerships Act 2000 will apply. If it is established as a private limited company, the provisions of the Companies Act 2006 will be relevant. LLPs have become increasingly popular as the structure for owner-managed fund management businesses.

As an LLP, or as a company, a private equity firm will be required to satisfy various organisational requirements. In particular, the governing statutes require such firms to make reports to their members, and these requirements can be supplemented by provisions of the underlying documents (the articles of association or the partnership agreement, as the case may be). But as the FSMA is the most important and wide-ranging piece of legislation in this area, this briefing will concentrate on the ways in which the FSMA can affect private equity.

REGULATION UNDER THE FSMA

Under the FSMA, as a general rule all persons that carry on "regulated activities" in or from the UK are required to seek authorisation from the FSA. Regulated activities are specified in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ("RAO"), which sets the boundary between what is and is not regulated by the FSA (often referred to as the "perimeter").

Regulated activities which private equity firms are likely to conduct include some or all of the following:

(a) dealing in investments as principal (RAO, article 14);

(b) dealing in investments as agent (RAO, article 21);

(c) arranging deals in investments (RAO, article 25);

(d) managing investments (RAO, article 37);

(e) safeguarding and administering investments, or arranging for the safeguarding and administration of investments (RAO, article 40);

(f) establishing or operating a collective investment scheme (RAO, article 51); and

(g) advising on investments (RAO, article 53).

A key point to note is that the FSMA applies only in respect of regulated activities carried on in the UK (FSMA, section 19). So if a private equity firm is established outside the UK (for example in the Channel Islands), it may be able to carry on business with clients in the UK without the need for authorisation by the FSA. For example, whilst the giving of investment advice to clients in the UK would be likely to constitute an activity carried on in the UK (as advice is normally regarded as given where it is received), investment management is usually carried on where the investment manager makes his decisions. A private equity firm located outside the UK that carried on only investment management, therefore, is unlikely to require FSA authorisation, though it may be required to satisfy local law requirements.[1]

The introduction of the FSMA and the RAO did not in themselves mark any great regulatory change for private equity firms. They had been required to be authorised for similar activities under the Financial Services Act 1986, in force from April 1988. However, the FSA, the single regulator established under the FSMA regime, has moved over time towards a regulatory regime which places increased emphasis on principles-based regulation focusing on outcomes, rather than the making of detailed rules. As part of this focus, the FSA has, for some time, stressed that senior managers of firms are responsible for ensuring that proper procedures are in place to enable compliance with the rules, and has indicated that it will take action against individuals, as well as their firms, if procedural failure results in breach of rules.

In addition, as part of its policy of "credible deterrence", the FSA has adopted a more aggressive approach to infractions of its rules generally, using its fining powers to impose significant penalties on wrongdoers. Although the Government has proposed that the FSA in its current form will disappear (with its powers divided between a Prudential Regulatory Authority ("PRA") and a Financial Conduct Authority ("FCA"), perhaps with effect from early 2013), there is no reason to suppose that the new regulators will be any less aggressive in this area.

THE FSA'S RULES

Like all other authorised firms, private equity firms are subject to the relevant parts of the FSA Handbook.

High level standards

These include the following:-

(a) The Principles for Businesses Sourcebook (PRIN)

PRIN contains the 11 Principles for Businesses, which set out the high level standards that apply to all regulated firms. The Principles cover areas such as integrity, management and control, market conduct, customers' interests and relations with regulators. Whilst contravention of a Principle does not give rise to a right of action for an affected person (such as a client) under section 150 of the FSMA, the FSA is increasingly using breach of a Principle as the grounds for taking enforcement action against firms.

(b) The Senior Management Arrangements, Systems and Controls Sourcebook ("SYSC")

SYSC sets out rules and guidance, drafted at a high level, on the systems and controls that firms need to have in place to satisfy their regulatory responsibilities. It requires firms to apportion responsibility appropriately between its senior management, and maintain systems and controls appropriate to the business carried on by the firm. So, whilst certain larger firms will need to have in place separate functions such as compliance, internal audit and risk assessment to satisfy their obligations under SYSC, this will not necessarily be the case for smaller firms, as the FSA has noted (SYSC 3.1.2G). SYSC also serves to emphasise the importance the FSA places on senior management taking responsibility for ensuring that firms comply with their regulatory responsibilities.

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1 Note, however, that the Court of Appeal decision in *FSA v. Fradley and Woodward* [2005] EWCA Civ. 1183 suggests that firms which wish to avoid coming within the scope of the FSMA must take care that any activity that takes place in the UK is not a significant part of a regulated activity. In that case, communications with clients in the UK, plus the maintenance of bank accounts and an accommodation address in the UK, were deemed sufficiently regular and substantive to constitute the operation of a collective investment scheme, even though all the elements of the regulated activity were not carried on in the UK.

SYSC 6.3 contains provisions relevant to financial crime. Under SYSC 6.3.1R, a private equity firm must ensure that its policies and procedures established to counter the risk that the firm might be used to further financial crime include systems and controls that enable it to identify, assess, monitor and manage money laundering risk. A director or senior manager must be given overall responsibility for the establishment and maintenance of effective anti-money laundering systems and controls; this is usually the person who acts as the firm's money laundering reporting officer ("MLRO"). In addition to the FSA's rules in this area, firms will also be subject to other provisions, in particular the Money Laundering Regulations 2007, which among other things require private equity firms to carry out customer due diligence measures as a means of identifying and verifying the identity of the customer and the purpose and intended nature of the business relationship.

"Customer due diligence measures" is defined as identifying the customer and verifying the customer's identity on the basis of documents, data or information obtained from a reliable and independent source. This process includes identifying all beneficial owners who are not the customer, such as (where the customer is an unlisted body corporate) a person with more than 25% of the shares or voting rights or (where the customer is a partnership other than an LLP) a person who is entitled to or controls more than a 25% share of the capital or profits of the partnership. Customer due diligence also requires the firm to obtain information on the purpose and intended nature of the business relationship.

Customer due diligence should be applied on a risk-sensitive basis, depending on the type of customer, business relationship, product or transaction. Firms will also need to demonstrate to the FSA, if so required, that the measures they have adopted are appropriate, so a documentary record of customer due diligence measures will need to be kept. The usual proofs of identity that firms require for individuals are a passport and recent utility bill, to confirm both name and address; but other proofs can be used, including assurances from reputable third parties (such as work colleagues, lawyers or bankers) who have known the person concerned for some time. In higher risk situations, enhanced due diligence measures are required. Such situations will arise, for instance, where the firm is dealing with a customer who is not present in the UK, and private equity firms with business interests in emerging markets therefore need to take particular care to comply with their anti-money laundering obligations. As an example, they will need to establish whether any overseas customers are "politically exposed persons" — persons exercising prominent public functions, or members of their immediate family, or known close associates — and, if they are, obtain senior management approval for establishing the business relationship, take adequate measures to establish the source of wealth and source of funds involved in the transaction, and conduct enhanced ongoing monitoring of the relationship.

Money laundering and bribery issues are closely related; and although SYSC contains no specific provisions relating to bribery, the FSA has noted on a number of occasions that firms will need to be aware of, and adopt appropriate procedures to avoid infringing, the provisions of the Bribery Act 2010, in order to satisfy their obligations under Principle 3 (Management and Control) of the Principles for Businesses. The FSA has already shown how seriously it regards failings in this area when in 2009 it imposed a fine of £5.25 million on a firm for having inadequate anti-bribery systems and controls, and thus being in breach of Principle 3.

SYSC 8 contains provisions relating to outsourcing that are likely to be relevant to many private equity firms. Under these provisions, which derive from the Markets in Financial Instruments Directive ("MiFID"), firms that outsource critical and important functions are required to take reasonable steps to avoid undue additional operational risk, and may not undertake such outsourcing if it materially impairs the quality of the firm's internal controls or the ability of the FSA to monitor the firm's compliance with its regulatory obligations. SYSC 8 applies whether the firm's clients are professional or retail. Among the requirements of SYSC 8 are for a formal outsourcing agreement to be entered into, which will apply even if the outsourcing is intra-group. If, however, the fund rather than the firm does the outsourcing (for instance, appointing an administrator itself), and the fund is not a regulated person, SYSC 8 will not apply.

Under SYSC 10, private equity firms are required to maintain and operate a policy for identifying and managing conflicts of interest, and to have effective arrangements in place with a view to taking all reasonable steps to prevent conflicts of interest arising which could give rise to a material risk of damage to the interests of the firms' clients. Unlike under the rules that applied before MiFID was implemented on 1 November 2007, disclosure of the conflict cannot be used as a primary means of managing a conflict, but only once all other arrangements have failed to remove the conflict (SYSC 10.1.7R and 10.1.8R).

The FSA's new Remuneration Code (SYSC 19A) will be relevant to only a few private equity firms (as it is unlikely to apply to advisers on and arrangers of investment transactions, whether the firm is subject to MiFID or not). The Remuneration Code establishes a general requirement for firms within its scope to have remuneration practices in place that contribute to successful risk management, and this is supported by 12 "remuneration principles". Among other things, the "remuneration principles" require as a general rule that at least 40% of bonuses paid to "Remuneration Code staff" — staff whose professional activities have a material impact on the firm's risk profile — must be deferred for a period of not less than three to five years, and at least 50% of bonuses should be paid in shares in the firm or share-linked instruments. However, the FSA's adoption of a proportionate approach in applying the Remuneration Code means that most of the detailed requirements regarding remuneration structures are unlikely to apply to private equity firms in any event.

(c) The Statements of Principle and the Code of Practice for Approved Persons ("APER") and the Fit and Proper Test for Approved Persons ("FIT").

APER and FIT do not apply to private equity firms as such, but they are relevant for any employee that carries out a "controlled function" on behalf of the firm.[2] Controlled functions include governing functions (such as being a director or partner) and the customer function (which covers, among other things, advising on investments and acting as an investment manager). Applications for approval to carry out a controlled function are made by the firm on the relevant person's behalf.

Prudential standards

The prudential requirements for private equity firms — that is, the amount of regulatory capital firms need to have — depend on whether the firm is within the scope of MiFID or not.

Firms that are outside the scope of MiFID are subject to the requirements of the interim prudential sourcebook for investment firms (IPRU (INV)), which has largely remained unchanged since the FSMA came into force. These will include firms that act as operators of collective investment schemes. Such firms are subject to relatively low capital requirements: for example, an own funds level of £5,000 if the firm does not deal with retail customers.

A firm within the scope of MiFID but whose MiFID business is restricted to receiving and transmitting orders and/or providing investment advice, and which does not hold client assets, will be subject to a capital requirement which allows it to hold own funds of €50,000 or a prescribed level of professional indemnity insurance (at least €1,000,000 applying to each claim and €1,500,000 per year in aggregate applying to all claims), or a mixture of the two that provides equivalent coverage (IPRU (INV) 9.2.4R).

Most private equity firms will come within one of the above categories. The minority of private equity firms which do not fall within those categories will be subject to the prudential sourcebook for banks, building societies and investment firms (BIPRU), which incorporates the Capital Requirements Directive ("CRD"). The amount of regulatory capital required will depend on the type of business that the firm carries on and, if the firm is a member of a group, whether that group is subject to consolidated supervision or not.

Conduct of business requirements

Prior to MiFID coming into effect, the conduct of business requirements on private equity firms were generally light. This was because most clients of private equity firms could be classified as intermediate customers, in respect of whom many rules either did not apply (such as the suitability requirement) or could be made not to apply (such as the best execution requirement).

For a private equity firm acting as a manager of a fund, the firm's client will be the fund, not the individual investors in the fund. In virtually all cases, the fund will be able to be categorised as a professional client under MiFID. However, the FSA's new conduct of business sourcebook ("COBS"), in force from 1 November 2007, has brought about wide ranging changes in the way in which professional clients are treated. In particular, firms need to provide both retail and professional clients with best execution, and apply the suitability test to their professional clients where they are providing investment advice or portfolio management services.

Whilst it is true that "best execution" will largely be an irrelevant concept when the fund manager is making unquoted investments (since the price agreed will be the only price available), firms will need to pay attention to best execution when stakebuilding in a listed company. And although certain parts of the suitability test (such as affordability) can be assumed for professional clients, firms will still need to establish whether the transaction to be recommended or entered into meets the professional client's investment objectives (COBS 9.2.2R and 9.2.8R). Furthermore, as the test for "opting up" a client to elective professional client status in respect of business covered by MiFID under COBS 3.5.3R now contains a quantitative test (satisfaction of two out of three stated criteria) as well as a qualitative one (sufficient knowledge and experience), it has become more difficult for firms to "opt up" retail clients. It will, however, remain possible for private equity firms to promote their funds to retail clients which satisfy the qualitative test only, as the exemption that applied under the old rules, allowing

[2] For a full list of controlled functions, see FSA's Supervision Manual ("SUP"), 10.4.

the promotion of unregulated collective investment schemes to expert private customers, has been preserved (see COBS 4.12.1R(4), category 8).

Private equity firms that operate collective investment schemes will be able to take advantage of the concessionary regime under COBS 18.5. This provides that only certain COBS rules apply to the operator and that the operator need not comply with any other COBS rule. In particular, the operator need not provide best execution if this is disclosed in the scheme documents and no participant in the scheme is (or was when joining the scheme as a participant) a retail client.

Other requirements

Unless they conduct business with clients within the scope of the FSMA complaints or compensation regime, private equity firms will not be subject to the relevant FSA manuals (DISP and COMP) and will not be required to contribute to the operation of the Financial Services Compensation Scheme or the Financial Ombudsman Service. They will however be required to contribute fees to the FSA, calculated in accordance with the appropriate tariff base.

The Training and Competence Sourcebook ("TC") will likewise apply only in limited circumstances, namely if the firm conducts business with retail clients. This means that a private equity firm conducting business exclusively with professional clients need not require its employees to have passed an appropriate examination (TC 2.1.6R), although it is likely that many firms will require such a proof of competence. Instead, it will be enough for the firm to satisfy the high-level requirement in SYSC 3.1.6R (or for MiFID firms, SYSC 5.1.1R) to employ persons with the necessary skills, knowledge and expertise.

PASSPORTING UNDER MIFID

Since the coming into force of MiFID private equity advisers have had a new string to their bow. Those whose regulated activities in the United Kingdom consisted only of the provision of investment advice, and not any other "core" activity, could not, under the now defunct Investment Services Directive ("ISD"), offer their services on a cross-border or passported basis in the EU/EEA. MiFID, as successor in this respect to the ISD, now provides that investment advice is a core service enabling private equity advisers to benefit from the European passport and provide cross-border services, although this would require them to "opt in" to MiFID (as they would otherwise be excluded under the optional MiFID exemption, which the United Kingdom has applied, for firms which only advise on and/or arrange investment transactions). As with hedge fund managers, it is unlikely that any would see the need to establish branches elsewhere. On the other hand, the ability to provide investment advisory services on a "flying in and out" basis may have some attraction.

PROMOTION OF PRIVATE EQUITY FUNDS

Private equity funds are typically structured as limited partnerships. As such, they are classified, for the purposes of UK regulation, as unregulated collective investment schemes. This means that the ability of the manager or other third party, such as a promoter, to market such funds to persons in the UK is restricted.

If the person doing the marketing is not authorised by the FSA, that person will be able to market the fund only to persons within one or more exemptions in the Financial Services and Markets Act 2001 (Financial Promotion) Order 2005. Exemptions which are likely to be useful here are those covering investment professionals, high net worth individuals and companies, and sophisticated investors.

If the person doing the marketing is an FSA authorised firm, the marketing scope is extended. Among other possibilities, authorised firms can promote private equity funds to anyone classified as a professional client, and also to a retail client who has been assessed by the firm as sufficiently knowledgeable to make his own investment decisions and to understand the risks involved (see COBS 4.12.1R(4), categories 7 and 8).

INVESTING IN LISTED COMPANIES: ISSUES TO CONSIDER

Buy-out firms regularly build stakes in, and acquire, listed companies. In doing so they walk over a regulatory minefield. Booby traps include the Takeover Code, market abuse and transparency obligations. To reach safety quickly, skilled navigation is required. This section summarises the obstacles that need to be navigated.

General restrictions on acquisitions of shares

(a) Insider dealing

In contemplating arrangements involving the acquisition of shares on a UK regulated market, it is important to consider whether any share dealings might constitute an offence under the insider dealing legislation contained in the Criminal Justice Act 1993. Offences under the insider dealing legislation are committed by individuals rather than companies and so it is the knowledge and actions of those individuals involved which is important and, specifically, whether such individuals are in possession of inside information at the time they deal or encourage another to do so.

There is a general defence in the context of stakebuilding, which relates to the possession of market information. Where a person's only inside information is "market information" as to the acquisition or proposed acquisition of securities and the identity of the persons involved or likely to be involved in such acquisition, no offence will be committed. Firms will however need to be careful when carrying out due diligence on a potential target that, in so doing, they do not acquire information which would make them "insiders" and as such restricted as to subsequent stakebuilding.

(a) Market abuse

In addition, account should be taken of the market abuse provisions of section 118 of the FSMA. The basic market abuse offence is now detailed in sections 118 and 118A of FSMA. Market abuse is behaviour (which includes action or inaction) which both:

- occurs in relation to "qualifying investments" admitted (or in respect of which a request has been made for admission) to trading on a "prescribed market" (or in the case of insider dealing and the improper disclosure behaviours only, in relation to investments which are "related investments" to such qualifying investments (that is, an investment whose price or value depends on the price or value of the qualifying investment)); and
- falls within any one or more of the seven types of behaviour set out in section 118(2) to (8) of the FSMA, that is:
    - ❑ insider dealing (*section 118(2)*);
    - ❑ improper disclosure of inside information (*section 118(3)*);
    - ❑ misuse of information (*section 118(4)*);
    - ❑ manipulating transactions (*section 118(5)*);
    - ❑ manipulating devices (*section 118(6)*);
    - ❑ disseminating information likely to give a false or misleading impression (*section 118(7)*); and
    - ❑ misleading behaviour or market distortion (*section 118(8)*).

The FSA has issued a code of market conduct containing descriptions of the behaviour, which, in the FSA's opinion, does (or does not) amount to market abuse. It is necessary, therefore, to have regard to the code of market conduct in determining whether the stakebuilding behaviour involves any abuse.

Disclosure and Transparency Rules

A acquisition of "shares" may incur an obligation to notify the voting rights in respect of those shares in accordance with Chapter 5 of the FSA's Disclosure Rules and Transparency Rules ("DTR"). The reference to "shares" in the DTR is to a company's issued shares which carry the right to vote in all circumstances at general meetings of shareholders. The term also includes any shares which on the occurrence of an event of default or the exercise of a right of conversion become fully enfranchised for voting purposes. However, the provisions of Chapter 5 only apply where the shares in question are admitted to trading on a regulated or prescribed market in the UK, which includes the AIM market of the London Stock Exchange as well as the markets for listed securities.

The basic disclosure obligation is contained in DTR 5.1.2R, which states that a person must notify an issuer of the percentage of its voting rights he holds as a direct or indirect holder of shares or through his direct or indirect holding of financial instruments (which includes swaps, options and other contracts, provided they result in an entitlement to acquire, on the holder's own initiative, shares to which voting rights are attached), if the percentage of those rights reaches, exceeds or falls below 3%, 4%, 5%, 6%, 7%, 8%, 9%, 10% and each 1% threshold thereafter up to 100%. In the case of non-UK issuers, whose shares are admitted to trading on a regulated or prescribed market in the UK, the percentage thresholds of voting rights are different, being 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75% .

A contract for differences ("CFD") is treated as a financial instrument to which DTR 5.1.2. applies if the holder of the CFD is entitled under a formal agreement to require shares to be delivered to him on closing out the contract. However, the holder of a long CFD may, nonetheless, incur an obligation to notify the voting percentage in respect of shares acquired as a hedge by the CFD counterparty if the holder controls the exercise of the voting rights attached to such shares.

If the voting rights attaching to shares acquired by a counterparty under a CFD are exercisable at the discretion of the investment manager by agreement with the counterparty then the investment manager may (subject to the applicable thresholds) incur an obligation to notify the voting percentage in respect of the shares concerned in its capacity as an indirect holder of the same.

Where a notification is required under DTR 5.1.2, it must include the following information:

- the resulting situation in terms of voting rights;
- the chain of controlled undertakings through which voting rights are effectively held (where applicable);
- the date on which the applicable threshold was reached or crossed; and
- the identity of the shareholder, even if that shareholder is not the person entitled to exercise the voting rights, together with that of the person who is entitled to exercise such voting rights.

The notification to the issuer must be effected as soon as possible, but not later than four trading days in the case of a non-UK issuer and two trading days in all other cases, with the period beginning on the day after that on which the relevant person learns of the acquisition or the possibility of exercising voting rights or should have learned of it. DTR 5.9.1R also states that a person making a notification to an issuer must, if the shares are admitted to trading on a regulated market in the UK, at the same time file a copy of such notification with the FSA.

The FSA can impose a penalty if it considers that a person has contravened the DTR. It also has certain powers to ensure that the required information is disclosed to the market, including the power to prohibit trading in a company's shares and the power to require certain information to be disclosed to it.

Requirements under the Takeover Code

Under certain circumstances it is necessary in addition to address the requirements of the rules (the "Rules") of the City Code on Takeovers and Mergers ("Code"). This can be a complex area and this analysis provides an overview only.

The Code applies to all takeover (tender) offers for companies which have their registered offices in the United Kingdom, Channel Islands or the Isle of Man, if any of their securities are admitted to trading on a regulated market in the UK or on any stock exchange in the Channel Islands or the Isle of Man. It also applies to offers for any public companies with registered offices as above and which are considered by the Panel on Takeovers and Mergers (the "Panel") to have their place of central management and control in the United Kingdom, Channel Islands or the Isle of Man. In certain other, and less common, circumstances not discussed here, the Code also applies.

The provisions of the Code will be important in relation to any company that is in an "offer period"; that is, the period commencing with the date of an announcement of a proposed or possible offer relating to the company and ending on the first closing date of the offer or, if later, the date upon which the offer becomes or is declared unconditional as to acceptances or lapses. However, certain other provisions relating to the acquisition of interests in shares and the making in consequence of a compulsory offer (Rules 5 and 9) will apply *irrespective* of whether or not the company concerned is in an offer period.

(a) Interest in securities

A term which is important to understand in the context of the Code is that of an "interest in securities", which includes an interest in shares. A person who has a long economic exposure, whether absolute or conditional, to changes in the price of shares will be treated as interested in those shares. However, a person who has only a short position will not be treated as having an interest in shares. In particular, a person will be treated as having such an interest in shares if:

- he owns them;
- he has the right (whether conditional or absolute) to exercise or direct the exercise of the voting rights attaching to them or has general control of them;

- by virtue of any agreement to purchase, option or derivative he:

  - has the right or option to acquire them or call for their delivery; or

  - is under an obligation to take delivery of them,

  whether the right, option or obligation is conditional or absolute and whether it is in the money or otherwise; or

- he is party to any derivative:-

  - whose value is determined by reference to the price of the shares; and

  - which results or may result in his having a long position in them.

Where shares have been borrowed or lent, a person will normally be treated as interested in any shares he has lent, but not in those he has borrowed.

(b) Acting in concert

A number of the provisions of the Code require consideration of the actions of persons, together with their related parties with whom they are treated as "acting in concert". For these purposes:

"Persons acting in concert comprise persons who, pursuant to an agreement or understanding (whether formal or informal), co-operate to obtain or consolidate control (as defined below) of a company or to frustrate the successful outcome of an offer for a company."

In this connection, the following are presumed, unless the contrary is established, to be acting in concert:

- a company, its parent, subsidiaries and fellow subsidiaries and their associated companies and companies of which such companies are associated companies (for which purpose ownership or control of 20% or more of the equity share capital of a company will be regarded as the test of associated company status);
- a company with any of its directors (together with their close relatives and related trusts);
- a company with any of its pension funds and the pension funds of any company mentioned in the first bullet above;
- a fund manager (including an exempt fund manager[3]) with any investment company, unit trust or other person whose investments such fund manager manages on a discretionary basis, in respect of the relevant investment accounts;
- a connected adviser with its client and, if its client is acting in concert with an offeror or with the offeree company, with that offeror or with that offeree company respectively, in each case in respect of the interests in shares of that adviser and persons controlling, controlled by or under the same control as that adviser (except in the capacity of an exempt fund manager or exempt principal trader); and
- directors of a company which is subject to an offer or where the directors have reason to believe a bona fide offer for their company may be imminent.

(c) Rule 5 of the Code (Timing Restrictions on Acquisitions)

Rule 5.1 states that except as permitted by Rule 5.2 (see below), when a person (which includes any person acting is a concert with him) is interested in shares which in the aggregate carry less than 30% of the voting rights of a company, he may not acquire an interest in any other shares carrying voting rights in that company, which when aggregated with the shares in which he is already interested, would carry 30% or more of the voting rights. Similarly,

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3 A person who manages accounts on a discretionary basis and who is recognised by the Panel as such for the purposes of the Code.

when any person is interested in shares which in aggregate carry 30% or more of the voting rights of a company but does not hold shares which carry more than 50% of the voting rights, he may not acquire an interest in any other shares carrying voting rights in that company.

Rule 5.2 contains several relaxations of this Rule. The main one is that the prohibition does not apply to an acquisition at any time from a single shareholder if it is the only such acquisition within any period of seven days. Note that this exception does not apply where the person making the acquisition has announced a firm intention to make an offer and the posting of the offer is not subject to any pre-condition. The prohibition is also relaxed if the acquisition is made following the announcement of a firm intention to make an offer by the person making the acquisition, provided that the posting of the offer is not, at the time of the acquisition, subject to a pre-condition and that either the acquisition is made with the agreement of the board of the offeree company, the offer or any competing offer has been recommended by the board of the offeree company, or the offer has become unconditional in all respects.

(d) Rule 9 of the Code (Where a Mandatory Offer is Required and Who is Primarily Responsible for Making It)

Rule 9 states that, except with the consent of the Panel, when:

(ii) any person acquires, whether by a series of transactions over a period of time or not, an interest in shares which (taken together with shares in which persons acting in concert with him are interested) carry 30% or more of the voting rights of a company; or

(iii) any person, together with persons acting in concert with him, is interested in shares which in aggregate carry not less than 30% of the voting rights of a company but does not hold shares carrying more than 50% of such voting rights and such person, or any person acting in concert with him, acquires an interest in any other shares which increases the percentage of shares carrying voting rights in which he is interested,

such person shall extend offers to the holders of any class of share capital, whether voting or non-voting and also to the holders of any other class of transferable securities carrying voting rights.

The notes on Rule 9.1 include some specific provisions which may be relevant to those interested in, or seeking to acquire an interest in, shares. When a party has acquired an interest in shares without the knowledge of other persons with whom that party subsequently comes together to cooperate as a group to obtain or consolidate control of a company, and the shares in which they are interested at the time of coming together carry 30% or more of the voting rights of that company, the Panel will not normally require a general offer to be made. However, such parties having once come together, the provisions of Rule 9 will apply to any further acquisition of shares by any member of the group. In that context, the Panel does not normally regard the action of shareholders voting together on a particular resolution as an indication of itself that such parties are acting in concert. However, the Panel will normally presume that shareholders who requisition or threaten to requisition the consideration of a board control seeking proposal either at an annual general meeting or at an extraordinary general meeting, in each case together with their supporters as at the date of the requisition or threat, to be acting in concert with each other and with the proposed directors. Such parties will be presumed to have come into concert once an agreement or understanding is reached between them with respect to a "board control seeking" proposal, with the result that subsequent acquisitions of any interest in shares by any member of the group could give rise to an offer obligation.

In determining whether a proposal is board control seeking, the Panel will have regard to a number of factors including the following:-

- The relationship between any proposed directors and any of the proposed shareholders proposing them or their supporters. Relevant factors in this regard will include:
    - ❑ whether there is or has been any prior relationship between any of the activist shareholders or their supporters and any of the proposed directors;
    - ❑ whether there are any agreements, arrangements or understandings between any of the activist shareholders or their supporters and any of the proposed directors with regard to their proposed appointment; and
    - ❑ whether any proposed directors will be remunerated in any way by any of the activist shareholders or their supporters as a result of or following their appointment.
- If there is no relationship between any of the proposed directors and the activist shareholders or their supporters, or if any such relationship is insignificant, the proposal will not be considered to be board control seeking so as to mean that the parties are presumed to be acting in concert. If, however, such

a relationship does exist which is not insignificant, the proposal may be considered to be board control seeking, depending on:

- the number of directors to be appointed or replaced compared with the total size of the board;
- the board positions held by the directors being replaced and to be held by the proposed directors;
- the nature of the mandate (if any) for the proposed directors;
- whether any of the activist shareholders will benefit directly or indirectly as a result of the proposal, other than through its interest in shares; and
- the relationship between the proposed directors and the existing directors and/or the relationship between the existing directors and the activist shareholders.

(e) Rule 8 of the Code (Disclosure of Dealings and Positions)

The obligation to disclose dealings in relevant securities during the offer period extends to any person, whether or not an associate of the offeror or offeree companies, who is interested (directly or indirectly) in 1% or more of any class of relevant securities of the offeror or offeree companies or who will as a result of any transaction become so interested. Any dealings by any such person (or any person through whom his interest is derived) must be publicly disclosed in accordance with notes 3, 4 and 5 of the Notes on Rule 8.

(f) Rule 35 of the Code (Restrictions Following Offers)

Firms should note that if the offer is withdrawn or otherwise lapses, there is a restriction on dealing in the securities in the 12-month period following the withdrawal or lapse of the offer. In brief, the firm cannot in that period acquire shares in the company that would mean that the firm would have to make an offer under Rule 9, nor announce a further offer or possible offer for the company concerned.

Key Thresholds — Summary

By way of summary, the thresholds at which key disclosure and regulatory obligations are liable to be encountered are set out below.

Percentage of shares or voting rights in target	Consequence
Any amount (whether or not in an offer period)	Acquisition may be prohibited (Rule 5 of the Code) or result in a requirement for a cash offer to be made for the target (Rule 9 of the Code) if aggregate holding reaches 30% or more or if acquisition is in addition to an existing 30% holding.
Any amount during an offer period	Obligation on those interested in 1% or more of any class of relevant securities to disclose dealings (Rule 8.3).
3%	Obligation to disclose holdings of voting rights as a shareholder in company admitted to a regulated or prescribed market (DTR).
25%	Power to block special resolutions of company.
30%	May be prohibited from dealing (Rule 5 of the Code).
30%	Possible requirement to bid for remaining shares in company (Rule 9 of the Code)
More than 50%	Majority control.

THE WALKER GUIDELINES AND THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE ("AIFMD")

The Walker Guidelines

In 2007, the private equity industry responded to widespread concern about its lack of accountability by commissioning Sir David Walker to carry out a review of the adequacy of disclosure and transparency in private equity. This review resulted in the publication of the "Guidelines for Disclosure and Transparency in Private Equity" in November 2007 (the "Guidelines"), often referred to as the "Walker Guidelines".

Compliance with the Guidelines is voluntary, and there are no sanctions for failure to comply with them. However, the Guidelines Monitoring Group ("GMG") monitors conformity with the Guidelines and makes recommendations for changes to the British Venture Capital Association ("BVCA"), who commissioned the original Walker review. In its report of December 2010, the GMG noted that 35 private equity firms had agreed to comply with the guidelines during the previous year, and that compliance with the provisions of the Guidelines was higher than in previous years. In the GMG's view, this reflects the high level of commitment to the Guidelines from the private equity industry.

Whilst several of the guidelines relate to enhanced disclosure by "portfolio companies" (UK companies of a specified size which have been acquired in a public to private transaction or in a secondary buy-out by one or more private equity firms) and thus lie outside the scope of this note, others relate to additional disclosure by private equity firms themselves.

The Guidelines state that a private equity firm should publish an annual review accessible on its website, or ensure regular updating of its website, to communicate:

(a) a description of the way in which the firm fits into the group of which it is a part, the firm's history and investment approach, including investment holding periods, where possible illustrated with case studies;

(b) a commitment to conform to the Guidelines on a "comply or explain" basis and to promote similar conformity on the part of the portfolio companies owned by the firm's fund or funds;

(c) an indication of who the senior members of the management in the UK are, together with a confirmation that arrangements are in place to deal appropriately with conflicts of interest;

(d) a description of UK portfolio companies in the firm's portfolio; and

(e) a categorisation of the limited partners in the funds that invest in UK portfolio companies, by geographical location and type of customer (such as pension funds, corporate investors, banks, academic endowments, and private individuals).

The Guidelines also provide that when reporting to their limited partners, private equity firms should follow established guidelines in relation to reporting and monitoring (those of the European Private Equity and Venture Capital Association ("EVCA") are specifically mentioned in this context) and specified guidelines in relation to valuation. Private equity firms should also provide the BVCA with various types of data (such as the acquisitions and disposals of UK companies in the previous calendar year by transaction value) to support the move to establish the BVCA as the recognised authoritative source of intelligence and analysis of private equity matters in the UK. Finally, firms should ensure timely and effective communication with employees of portfolio companies at a time of significant strategic change.

The Guidelines were clearly designed to forestall primary legislation and the regulation that would inevitably follow, and Sir David Walker acknowledged as much in his review. Indeed, peer pressure to adopt the guidelines means that private equity firms are in practice finding themselves obliged to comply with wide-ranging disclosure provisions monitored by the BVCA, along with the various requirements of the FSA. At one stage, it looked as if the Guidelines might have succeeded in their aim, given that there seemed no appetite at a UK level to impose further regulation on private equity firms, and the view of the European Commission appeared to be that private equity posed no significant threat to financial stability (a dominant concern following the credit crisis of 2007–2008). However, the appearance of the AIFMD has changed that picture entirely, since the breadth of the AIFMD's scope means that it includes not only hedge funds, but also private equity firms.

The AIFMD

Although the AIFMD will not come into force in the United Kingdom until July 2013, it is worth mentioning a few of its main implications.

- The AIFMD will apply to all private equity firms with assets under management in excess of €100 million. This threshold is raised to €500 million if there is no leverage and there is a lock-in period of five years or more. The higher threshold may be helpful for private equity firms in that it will exclude many start-up and venture capital funds. However, it will be of less value to buyout funds. Firms that manage assets below these thresholds are required under the AIFMD to be registered with their home Member State regulator and to provide the regulator with details of their investment strategies, the main investments in which they are trading, and their principal exposures. This is unlikely to make any material difference to the position in the UK, where private equity firms carrying on regulated activities are required to be FSA authorised in any event.

- The AIFMD requires firms within its scope to have minimum regulatory capital of €125,000. This could be a big (and costly) change for those UK private equity firms who are currently obliged to hold only £5,000 by way of regulatory capital. In addition, there is an extra capital requirement, capped at €10 million, of 0.02% of the value of assets under management in excess of €250 million.

- The AIFMD allows a firm within its scope to market its funds to professional investors in its home Member State. It also creates a marketing "passport" allowing that firm to market its funds to professional investors in other Member States free of local legislation. This aspect will be very welcome to those private equity firms who currently struggle with a multitude of local marketing requirements. However, the "passport" will initially apply only to private equity funds domiciled in the EU. It will not apply to private equity funds domiciled outside the EU until late 2015, and then only if certain conditions apply (such as the country in which the funds are domiciled entering into an agreement with the Member State where the marketing is to occur under which tax information on individuals is to be shared in compliance with Article 26 of the OECD Model Tax Convention). This latter requirement may restrict the usefulness of the "passport".

- The AIFMD requires firms within its scope to appoint an independent depositary to hold the assets of the fund. For an EU private equity fund, the depositary must be in the same Member State as the fund. The benefit of this requirement for private equity firms is disputed; less so the likelihood of increased costs to those firms as a result.

- The AIFMD contains remuneration principles with which firms within its scope must comply in a way and to the extent appropriate to their size, internal organisation, and the nature, scope and complexity of their activities. These principles cover such matters as a restriction on guaranteed bonuses (only in exceptional cases and limited to the first year of a new hire) and the requirement for an appropriate balance between fixed salary and bonus. The AIFMD principles are therefore likely to catch a large number of private equity firms that are currently outside the scope of FSA's Remuneration Code (see page 3 above), with the result that affected firms will need to review and amend their current remuneration policies and practices so that they are compliant with the AIFMD.

In addition to the general provisions mentioned above, the AIFMD contains specific provisions directed at private equity in Articles 26 to 30, summarised below.

- When the fund acquires, disposes of or holds shares of a non-listed company, the fund manager must notify its home state regulator of the proportion of voting rights held by the fund whenever the proportion reaches, exceeds or falls below 10%, 20%, 30%, 50% and 75%. However, because of the way "non-listed company" is defined for the purposes of the AIFMD, this requirement will not apply where the company has its registered office outside the EU. Nor will this requirement, or any of the other provisions below, apply where the non-listed company is a small and medium sized enterprise[4] or a real estate special purpose vehicle.

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[4] For this purpose, a small and medium sized enterprise is a company which employs fewer than 250 employees and either has an annual turnover which does not exceed €50 million, or a balance sheet total not exceeding €43 million.

- Where the fund acquires control over a non-listed company (that is, more than 50% of the voting rights are held by the fund or the fund and its related entities), the fund manager must, within ten working days of acquiring control, notify the non-listed company, its shareholders and the fund manager's regulator of:

    - ❑ the acquisition of control, and when control was reached;

    - ❑ the level of control in terms of voting rights; and

    - ❑ how control has been reached (*e.g.*, if the fund controls the company through a chain of undertakings).

In addition, the fund manager must request the board of directors of the non-listed company to inform the employees or their representatives of the change of control and the information outlined above, and use its best efforts to ensure that this occurs.

- When the fund acquires control over a non-listed or listed company, the fund manager must make a number of disclosures to the company, its shareholders and the fund manager's regulator:

    - ❑ the identity of the fund manager(s) which manage the controlling fund;

    - ❑ the policy for preventing and managing conflicts of interest (in particular between the manager, the fund and the company); and

    - ❑ the policy for internal and external communication relating to the company (in particular, as regards employees).

- When the fund acquires control over a non-listed company,[5] it must disclose to the company and shareholders the intentions of the fund with regard to the future business of the company and the likely repercussions on employment, including any material change in the conditions of employment. Again, the fund manager must request the board of directors of the non-listed company to inform the employees or their representatives of the change of control and the information outlined above, and use its best efforts to ensure that this occurs. The fund manager must also disclose to its regulator and the investors in the fund "information on the financing of the acquisition", which would appear to include all types of finance employed by the fund. Such disclosure will not be required from the fund's potential competitors, such as sovereign wealth funds and wealthy individuals.

- When the fund acquires control of a non-listed company, the fund manager must:

    - ❑ request and use its best efforts to ensure that the company's annual report includes certain additional information and is made available to all employee representatives or employees; or

    - ❑ include that information relating to that company in the annual report which the fund manager is required to produce under Article 22 of the AIFMD.

The additional information must include at least a fair review of the development of the company's business representing the situation at the end of the period covered by the annual report, along with an indication of:

- ❑ any important events that have occurred in the financial year;

- ❑ the company's likely future development; and

5 "Control" for the purposes of a listed company is defined by reference to Article 5(3) of the Takeover Directive (Directive 2004/25/EC). This gives individual EU Member States the power to determine what percentage of voting rights constitute "control" for listed companies with registered offices in that Member State. In the UK, for instance, the relevant percentage is 30%.

- information concerning acquisitions of own shares required by the Second Company Law Directive (Directive 77/91/EEC), including the number and nominal value of the shares and any consideration paid.

- When the fund acquires control of a non-listed or listed company with a registered office in the EU (other than a company which is a small and medium sized enterprise or a real estate special purpose vehicle), the fund manager must not, for the two-year period following the acquisition, facilitate or support certain types of distribution (which will include the payment of dividends and interest relating to shares), capital reduction, share redemption or acquisition of own shares by the company, or vote in favour of such actions. Indeed, the fund manager must use its best efforts to prevent such actions. While this provision does not outlaw all payments to shareholders, in broad terms the restriction means that payments can be made to shareholders only if, following the payment, the company's net assets are equal to or greater than the amount of subscribed capital plus undistributable reserves.

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