

Private equity funds

Briefing

MACFARLANES

Future regulation of UK private equity houses

Analysis of the EU Alternative Investment Fund Managers Directive

At the end of April 2009 the European Commission published a draft directive (the 'Directive'), the Alternative Investment Fund Managers Directive, in relation to regulation of 'alternative' fund managers. This note examines the proposals and how they will apply to UK private equity houses, whilst also providing our views on the substantial shortcomings and difficulties that are contained within the Directive.

Background and introduction

The stated aim of the Directive is to 'introduce and harmonise a comprehensive and effective regulatory and supervisory framework for all alternative investment fund managers in the European Union'.

The impetus behind the Directive stems from a number of political initiatives within the European Parliament designed to regulate both private equity funds and hedge funds and it is clear that there are a number of different driving forces behind the Directive. For example:

- political pressure, particularly in response to the 'credit crunch';
- a fallout from the Madoff affair. Many European funds of hedge funds (and even some UCITS funds) had invested (either directly or through feeder structures) considerable sums of money

with Madoff and many of these products were sold to individual investors. The implication is that if the managers of those products had been regulated, this may not have happened;

- a feeling within certain circles, that hedge funds, in particular, pose a systematic risk to global financial and banking systems; and
- the European Union itself had separately started a project to look at potential harmonisation of private placement regimes across the European Union, an area that is now covered by the Directive.

Various reports and hearings were commissioned and held by both the European Commission and the European Parliament in 2008 and early 2009 that led to the publication of the Directive. The Directive has generated much comment and criticism and, whilst it is likely that some changes will be made to the Directive before it is finalised, it is anticipated that it will be agreed at some point during 2010. Thereafter further and heavier regulation of the UK private equity industry will be implemented.

Once the Directive is finalised, it is expected to come into force around two years later. In that intervening period the 'Lamfalussy approach' will be used to proceed with the 'Level 2' implementing provisions. These will be more detailed rules/provisions building upon some of the high level provisions in the Directive, prepared on the basis of advice

provided by the Committee of European Securities Regulators (CESR). Various parts of the Directive are specifically stated to be subject to further detailed Level 2 implementing provisions. Following the Directive coming into force, there are further transitional provisions that will apply, in particular relating to the authorisation of non-EU managers and the marketing of non-EU funds.

One of the main criticisms of the Directive to date is that it does not distinguish between different types of alternative fund managers. Some of the provisions are specifically aimed at either hedge fund managers or private equity fund managers (for example, the new mandatory regime that will apply to certain private equity portfolio companies), but the bulk of the provisions apply to all alternative fund managers, irrespective of the underlying nature and type of funds that they manage. From a private equity perspective, it would have been more beneficial for there to have been private equity specific provisions reflecting the nature of private equity fund management and the fact that the majority of the underlying assets managed are not listed.

The Directive is aimed at the regulation of the fund managers, rather than the alternative investment funds themselves, unlike the approach taken in the UCITS Directive for retail funds. The accompanying Impact Statement makes it clear that there are valid reasons for establishing alternative funds in 'third country' jurisdictions. A far bolder

move (but politically unacceptable) would be to start a process whereby Member States would be obliged to create 'onshore' structures to accommodate alternative funds but this will, at present, be left to individual Member States.

The contents of the Directive

The rest of this note examines the contents of the Directive in detail and sets out our detailed comments on specific provisions. The chapters referred to below are the chapters within the Directive itself and each one is considered in the order they appear.

Subject matter and scope

Chapter I – General provisions

Article 1 of the Directive states that it lays down rules for the 'authorisation, ongoing operation and transparency' of the managers of alternative investment funds (AIFMs). Article 2 states that the Directive shall apply to all managers established in the EU that provide 'management services' to one or more alternative investment funds (being any fund which is not a UCITS) irrespective of whether the alternative investment fund (AIF or Fund) itself is domiciled inside or outside the EU, whether the AIFM provides services directly or by delegation, whether the AIF is open-ended or closed-ended and the structure of the AIF and/or the AIFM. Management services is defined as the activities of 'managing and administering' an AIF.

Comment – as drafted it seems unlikely that the Directive applies to those UK private equity houses that are authorised as advisers/arrangers rather than

managers or operators of collective investment schemes. Such advisers are usually providing advice to an offshore manager located in a jurisdiction outside the EU and therefore the proposals which are highlighted in Chapter VII of the Directive of this paper, which set out the criteria for marketing non-EU AIFs in the EU and for recognition of third 'country' AIFMs, will be of particular relevance to these advisers.

In addition, whilst it is clear that a UK regulated 'operator' of a fund would be an AIFM, it is less clear whether someone solely carrying out investment management activities (but not administration) would be an AIFM.

Which private equity houses would be covered by the Directive?

The Directive will apply to all AIFMs who carry out 'management services' in respect of alternative investment funds (being all funds, whatever their legal form, other than UCITS funds) subject to a number of exemptions, including the following:

- in the context of private equity fund managers, where (i) their assets under management (over all funds) do not exceed a threshold of €500m (ii) the portfolio of the funds consists of assets that are not leveraged and (iii) no redemption rights are exercisable by investors during a period of five years following the date of the AIF's constitution. Member States will be able to permit an AIFM not meeting these criteria to 'opt up' and to fall within the Directive's scope;

- managers established in the EU but which do not provide management services to a fund domiciled in the EU and do not market funds in the EU;
- EU regulated banks and credit institutions;
- certain EU regulated insurance and life assurance companies; and
- supranational institutions such as the World Bank, the EIB, the EIF and other supranational institutions where they manage one or more funds.

Comment – the exemptions are problematic for a number of reasons:

- it is not clear whether the €500m limit would include uncalled commitments of private equity funds and only a vague and unhelpful definition of 'leverage' has been given. It is highly likely that some managers may rise above and then fall below the €500m threshold from time to time depending on their investment cycle;
- in our view, it seems rather peculiar that banks, other credit institutions and insurance companies are exempt and it is not clear whether this exemption would apply to funds that are managed by such institutions or primarily to any balance sheet activities they undertake. An uneven playing field would be created; and
- in the context of the additional reporting and transparency obligations placed on portfolio companies as a result of the Directive's proposals, the Directive does not extend to other acquirers of private companies which themselves are not fund managers. Again, this would seem to create an

unequal playing field between, for example, sovereign wealth funds or similar 'individual' investors and private equity fund managers who rely on raising capital from a number of different sources.

It is also possible that the FSA may choose to apply the provisions of the Directive to all UK authorised alternative fund managers, irrespective of whether they meet the main exemption set out above (although, at present the FSA has not given any indication that it intends to do so). The Directive specifically contemplates that national regulators will be allowed to treat any AIFM as falling under the scope of the Directive. Whilst this would allow such managers a cross-border marketing passport they would have to comply with the more burdensome provisions of the Directive.

Chapter II - Authorisation of the AIFM

Chapter II sets out the procedural and other requirements relating to the need for an AIFM to be authorised in its EU home member state. The Directive does make it clear that AIFMs that are not authorised in accordance with the Directive, nor otherwise regulated in a member state, will not be allowed to provide 'management services' to any AIF or market an AIF within the EU.

Once an AIFM is authorised pursuant to the Directive it will then be allowed to market any funds that it manages on an EU basis but only to those investors who fall within the definition of a 'professional investor' contained in MiFID.

Comment – whilst the provisions of Chapter II will not be unduly onerous for UK based private equity houses (as they are already authorised by the FSA) this will be a new requirement in a number of other EU member states. In addition, some of the provisions for the authorisation process set out in the Directive will, no doubt, be different from current UK FSA authorisation practices and procedures. For example, an AIFM will be required to submit the AIF rules or instruments of incorporation of each fund the AIFM intends to manage to the FSA, together with information concerning the delegation of functions and proposed marketing activities (see Chapter VI below).

Chapter III - Operating conditions for the AIFM

Chapter III of the Directive sets out the operating conditions for AIFMs, including general conduct of business rules and provisions relating to conflicts of interest, risk management, regulatory capital and delegation of functions. In addition, the Directive includes provisions relating to liquidity management and investment in securitisation positions, which will not be relevant to most private equity houses.

Conduct of business

Article 9 states that each AIFM shall (i) 'act honestly, with due skill, care and diligence and fairly' in conducting its activities, (ii) 'act in the best interests of the AIF it manages, the investors of those AIFs and the integrity of the market' and (iii) ensure all investors are 'treated fairly'.

Article 9 also provides that no preferential treatment can be given to an investor unless

this is disclosed in the AIF rules or instrument of incorporation.

The provisions relating to conflicts of interest and risk management are fairly similar to those in the existing 'common platform' provisions of the FSA rules, although there is an obligation to segregate within an operating environment tasks and responsibilities which may be regarded as incompatible. The Directive also requires each AIFM to have a 'liquidity management system' for each AIF and to be able to monitor liquidity risk. Again these provisions are of limited relevance to private equity houses but there is no carve out, so an additional compliance burden will be created. The Directive also requires that the AIFM shall ensure that the functions of 'risk management' and 'portfolio management' are separated and subject to separate reviews. These provisions will be expanded by the Level 2 implementing measures in due course.

Comment – these provisions should not be unduly burdensome for UK private equity houses as they generally reflect current FSA rules. The provision that an AIFM must act in the best interests of the fund, its investors and the integrity of the market is however rather peculiar. It is clear that the interests of these groups may well diverge and it would be difficult to prove (or disprove) that a private equity manager is acting in the 'best interests' of the integrity of the market. The concept of acting 'fairly' is also vague.

It is not clear at this stage whether a preferential term granted by means of side letters, the existence of which is disclosed,

would be sufficient disclosure. This begs the question whether a disclosure that preferential treatment may be granted will be sufficient or whether full disclosure of side letter provisions needs to be provided for in the constitutional documents – ie in the LPA.

In addition, forcing smaller private equity houses to have separate risk and portfolio management functions is likely to be unduly burdensome.

Capital requirements

One of the most controversial parts of the Directive is the regulatory capital requirements for authorised AIFMs. Article 14 states that the capital requirements for AIFMs are as follows:

- an own funds requirement of at least €125,000;
- where the value of the portfolios managed by that AIFM exceeds €250m, an additional own funds requirement of 0.02 per cent of the amount which exceeds €250m; and
- provided that the own funds requirement of the AIFM shall always be an amount at least equal to one quarter of their annual expenditure.

Comment – these provisions are a radical departure from the existing regulatory capital requirements for UK based private equity fund managers/advisers. Much debate has focused on the €125,000 own funds requirement and the additional 0.02 per cent own funds requirement but the main change will be the imposition of an overriding minimum of a quarter of annual expenditure. Whilst most UK private equity managers have an own funds requirement of £5,000,

moving to an annual expenditure test would result in tying up substantial sums in regulatory capital.

Although the aim is apparently to ensure that an AIFM is sufficiently capitalised to be able to undertake an orderly liquidation process, if required, it is arguable that an appropriate fixed capital requirement would suffice. It seems illogical to require an AIFM that is not holding the AIF's assets/cash to be subject to this regime, as the regime for advisers (a €50,000 own funds requirement) would seem a more logical comparison. We anticipate heavy criticism of these provisions. In addition, the FSA may apply these revised regulatory capital provisions to all alternative fund operators/managers (even those falling outside the Directive) which could be a substantial impediment to the establishment of new businesses.

Organisational requirements

Article 16 and 17 impose two fundamental new obligations on private equity houses, being the need to (i) appoint an independent 'valuator' of funds assets and (ii) to appoint a custodian/depositary in respect of any assets belonging to the relevant AIF.

The independent 'valuator' is required to ensure that the assets of the AIFs are valued at least once a year and additionally at each time shares/units in the AIF are issued or redeemed. The independent valuator must have 'appropriate and consistent procedures' to value assets in accordance with existing applicable valuation standards and the rules applicable

to such valuations shall be laid down in the jurisdiction in which the AIF is domiciled or in the rules or instrument of incorporation of the AIF.

The depositary must be a credit institution authorised in the EU (rather than any authorised person which has regulatory approval to provide custody services) and must:

- receive all payments made by investors when subscribing for an interest in the AIF;
- safe keep any financial instruments which belong to AIF; and
- verify that the AIF or the AIFM on its behalf has obtained ownership of all other assets of the AIF.

Comment – although these provisions can be seen as a specific Madoff reaction (ie primarily aimed at hedge funds) they do apply to all AIFMs covered by the Directive.

It is not clear at this stage who or what will qualify as an 'independent valuator' and this will be subject to specific Level 2 implementing measures. Whilst it is hoped that an independent valuation will only be required annually, it is possible that the provisions relating to issue or redemption could be deemed to apply whenever interests in a private equity fund are transferred. It is expected that BVCA/EVCA valuation guidelines would qualify as appropriate valuation standards that would form the basis of any independent valuation.

In respect of the depositary requirements (which are particularly onerous), many UK private equity houses are authorised to

undertake their own custody/safekeeping functions and the costs of employing a third party to do so, (which will inevitably be passed on to investors) could be considerable. In addition, many UK and other EU banks are ill equipped or unwilling to provide custody/safe keeping functions for unlisted assets and these proposals would cause a considerable change to the way many UK private equity houses undertake the ongoing administration of their funds.

Delegation of AIFM functions

The Directive has stringent new provisions relating to delegation of functions, in that it requires any AIFM that delegates 'the task of carrying out on their behalf one or more of their functions' will need prior authorisation from the FSA for such delegation. Where the delegation concerns portfolio management or risk management then the delegatee must also be authorised as an AIFM to manage funds of the same type. Again these provisions will be subject to specific Level 2 implementing measures.

Comment – these provisions are far more extensive than the current FSA rules on delegation and outsourcing. Not only is prior FSA approval required (which itself would be time consuming and burdensome) it is not clear what functions would be caught by the requirement for regulatory approval. Delegation of fund administration would clearly be caught but it is not clear whether providing investment advice to an offshore or other fund manager would be 'portfolio management' that would require the adviser to be

authorised as an AIFM pursuant to the Directive.

Chapter IV - Transparency requirements

Chapter IV addresses political concerns concerning the supposed 'secrecy' and private nature of hedge funds and private equity funds and provides for increased disclosure.

Each AIFM, in respect of each AIF it manages, must make available an audited annual report for each financial year, to investors and to the local regulator within four months of the end of that year. The report must include a balance sheet, an income and expenditure account and a report on the activities of the AIF during the financial year, and it must be sent to fund investors and the home state regulator.

AIFMs are also subject to additional reporting requirements beyond the obligations to make available an annual report. For each AIF managed the AIFM must disclose the following to investors before they invest (as well as when there are any changes):

- the investment strategy and objectives of each AIF, the circumstances in which leverage can be used including the type and sources of leverage;
- a description of any delegated functions, including the identity of the valuator and depositary;
- a description of procedures concerning liquidity risk management, redemption rights and how the AIFM ensures fair treatment of investors; and
- circumstances whenever an investor obtains preferential treatment including

the identity of the investor and a description of the preferential treatment.

Again, the provisions regarding annual reports and disclosure to investors will be subject to Level 2 implementing measures.

Comment – it is probably correct to assume that the provision of annual reports to local regulators will not become publicly available information, but since the FSA is a public body for the purpose of freedom of information legislation this is not certain. The disclosure requirements to investors are broadly similar to information already disclosed in PPMs (or indeed the LPA) but there are additional reporting obligations to regulators and this will include information on types of instruments in which the relevant funds are trading, liquidity risk procedures, principal exposures and the most important concentrations of each AIF.

Chapter V – Obligations regarding AIFM managing specific types of AIF

The first part of Chapter V deals with funds employing 'high levels of leverage on a systematic basis' and is unlikely to be relevant to the majority of private equity funds and their managers.

However the second part of Chapter V deals with obligations relating to AIFMs which acquire a controlling influence in companies and are therefore primarily aimed at private equity fund managers. These detailed provisions apply where the AIFM, on behalf of the funds it manages acquires 30 per cent more of the voting rights of a listed or unlisted investee company domiciled in the

EU. There is however a carve out where the company is a small and medium enterprise, being one that employs fewer than 250 persons, has an annual turnover not exceeding €50m and/or an annual balance sheet not exceeding €43m.

Within four days of going through the 30 per cent threshold the AIFM must notify the unlisted company and its other shareholders of:

- the resulting situation in terms of voting rights; and
- the conditions under (and the date on) which the 30 per cent threshold was reached.

In the context of unlisted companies, when the 30 per cent voting threshold is reached additional information must be disclosed by the AIFM to the investee company, its shareholders, and representatives of employees (or if none, the employees themselves), namely:

- policies for preventing and managing conflicts of interest, in particular between the AIFM and the investee company;
- the policy for ‘external and internal communication’ of the issuer, as regards employees; and
- the ‘development plan’ for the investee company.

Again these provisions will be subject to Level 2 implementing measures.

In addition, the annual report must also include the following further information in respect of each unlisted company in which the AIF has invested, namely:

- presentation of revenue and earnings by business segment, statement on the progress of the company’s activities and financial affairs, assessment of expected progress and a report on significant events;
- financial risk associated with the capital structure of the investee company;
- with regard to employee matters, turnover, terminations, recruitment; and
- statement on significant divestment of assets.

This information must also be provided to the ‘representative of employees’ of the investee company.

Following an acquisition of 30 per cent or more of the voting rights of an issuer where that issuer is no longer admitted or traded on a regulated market (ie as a result of a public-to-private or similar take private transaction) the investee company must continue to report for two years thereafter on the basis that it was still a listed company.

Comment – these additional reporting obligations go somewhat further than what is already contained in the Walker provisions applying to larger UK private equity houses and their investee companies and will result in significant cost burdens in terms of compiling and disclosing the information. Much of the detail will be subject to the Level 2 implementing measures in due course.

Chapter VI - Provision of management and marketing services by the AIFM

This part of the Directive deals with the ability of an AIFM to provide management and marketing services on a cross-border basis

throughout the EU in respect of AIFs domiciled in the EU. Before an AIFM can market shares/units in an AIF to ‘professional investors’ (as per the MiFID definition) in its home member state it must submit a notification to its local regulator in respect of that AIF. Such notification will include information on the AIF itself, a copy of its rules or instrument of incorporation (eg its limited partnership agreement) and information on arrangements established to prevent shares being marketed to retail investors. Generally the regulator will have ten working days from receipt of notification from the AIFM to determine whether the marketing can commence. Member states can allow the marketing of AIFs to retail (ie non professional) investors in their country but may impose additional restrictions for these purposes.

Where an AIFM wishes to market its AIF in other EU member states, it must also notify its home regulator of that intention and provide the information outlined above together with information of the other member states in which it intends to market the AIF and details of the arrangements made for the marketing of that AIF in each member state.

Notification need only be made to the home member state of the AIFM and each home state regulator shall then notify the competent authorities in the host states that it has received such notification. Notwithstanding the cross-border ‘passport’ it is interesting that arrangements made for the marketing of an AIF in a host state (ie non home state of the AIFM) will still be subject to the ‘laws

and supervision of the host Member State' (Article 35(4)). This may undermine the value of the passport.

In addition, in the event of any change in any of the information communicated to the home member state, the AIFM is required to give written notice of that change 'at least one month before implementing the change'. The key issue here is that it appears that the documentation must be in final form before it is dispatched – otherwise amendments will need to be approved by the regulator with one month's notice given. This is not in accordance with accepted private equity fund practice.

The Directive also allows an AIFM authorised in one member state to provide management services in relation to funds domiciled in other EU member states either directly or by the establishment of a branch. Again prior to providing such cross-border management services, notification needs to be made to the home member state regulator of the intention to do so. Most member states are not allowed to impose any additional requirements on the AIFM providing cross-border management services.

Comment – again these provisions are generally more draconian than the current private placement regimes existing across EU member states. Notwithstanding the lack of harmonisation at present and the need to examine local law requirements in each jurisdiction, there is generally no obligation to notify EU member states of marketing of private funds and therefore these proposals are a radical departure from

existing regimes. In addition marketing is only allowed to be made to 'professional investors' under the fairly strict definition contained within MiFID and this would preclude certain high net worth individuals and sophisticated investors who may not fall within the definition. This could be particularly problematic in respect of 'friends and family' funds or indeed any marketing of an AIF to an AIFM's own members of staff and related parties.

The obligation to give one month's advance notice of any change to the information provided to the regulator will also prove problematic in practice as it would seem to imply that any changes to a PPM or limited partnership agreement that arise during the negotiation of such documentation cannot be implemented until the one month period had elapsed.

It is also not clear what the regime would be for the marketing of funds that are managed by an AIFM not caught by the Directive – originally this would be existing private placement regimes which are themselves fairly restrictive in certain member states.

Chapter VII – Specific rules in relation to third countries

Some of the most important parts of the Directive are those that deal with the conditions for the marketing within the EU of AIFs that are domiciled in jurisdictions outside the EU, so called 'third countries' and from a private equity perspective this will, in particular, include funds established in Jersey/Guernsey and also those established in the Cayman Islands. Importantly these provisions will also impact on the ability of

US private equity fund managers to market their onshore and offshore private equity funds to investors within the EU.

There are two separate provisions in the Directive – one dealing with the ability of AIFMs established in the EU to market within the EU an AIF domiciled in a third country in the EU (Article 35) and secondly provisions regarding the authorisation of AIFMs established in third countries (ie those not covered and authorised under the Directive) to market any AIF to 'professional investors' within the EU (Article 39).

An EU authorised AIFM can only market shares of an AIF domiciled in a third country to professional investors within an EU member state if that third country has signed an agreement with the home member state of the AIFM which complies with standards laid down in Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information in tax matters. Again the notification requirements set out above for marketing EU domiciled AIFs will also need to be followed and the member states may extend the ten day period which they have to approve or otherwise the marketing if they need more information about the third country. It will be necessary to have an agreement between the member state and the third country for each member state in which the relevant AIF will be marketed and there does not seem to be any provision for an overarching agreement with the Commission itself. It is therefore possible that the approach taken by member states may vary, notwithstanding compliance by

the third country with the requirements laid down in the Directive.

The provisions dealing with marketing of funds by AIFMs outside the EU are far more stringent. Member states are allowed to authorise non-EU AIFMs to market an AIF to professional investors in the EU providing that:

- the third country is subject to a decision taken by the European Commission that its legislation regarding prudent regulation and ongoing supervision is ‘equivalent’ to the provisions of the Directive and is effectively enforced;
- the third country is subject to a decision taken by the European Commission stating that it grants AIFMs established in the EU effective market access ‘comparable to that granted by the EU’ to AIFMs from that third country;
- the AIFM provides the competent authority of the member states in which it wishes to market the information set out in Articles 5 (information supplied prior to becoming authorised in a member state) and Article 31 (information supplied prior to the marketing of an AIF);
- a co-operation agreement between the competent authorities of that member state and the local supervisor of the AIFM exists which ensures an efficient exchange of all information that is relevant for monitoring the potential implications of the activities of the AIFM for ‘the stability of systematically relevant

financial institutions and the orderly functioning of markets’; and

- the third country has an agreement with the member state which complies with Article 26 of OECD Model Tax Convention and ensures an effective exchange of information in tax matters.

Level 2 implementing measures will be adopted aimed at establishing ‘equivalent’ criteria for the equivalence and effective enforcement of third country legislation based on the general requirements laid down in the Directive and also general criteria for assessing whether third countries grant AIFMs established in the EU effect market access granted by EU to AIFMs from those third countries.

Comment – the provisions of the Directive dealing with marketing are some of the most problematic. Whilst certain third country jurisdictions such as Guernsey and Jersey will, we believe, do everything they possibly can to become ‘equivalent’ for the purposes of the Directive, jurisdictions such as the United States and other popular offshore jurisdictions are unlikely to be willing to comply with the procedures required by the Directive.

Chapter IX – Transitional provisions

Timing on implementation of the Directive is still uncertain but there are a couple of important transitional provisions. First, AIFMs in the EU shall have one year after implementation of the Directive to adopt all

necessary measures to comply with the Directive and submit any relevant applications for authorisation. This is unlikely to be unduly burdensome for existing UK regulated private equity houses that are already FSA authorised but it is not yet clear whether any additional information/reporting provisions which are required by the Directive would have to be complied within that one year transitional period.

There is a separate three year transitional period in respect of the provisions of Chapter VII of the Directive (which deals with the rules relating to third countries) so that the existing private placement regimes will continue for such three year period.

Contact details

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