The Private Equity Review

Fifth Edition

Editor
Stephen L Ritchie

Law Business Research

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EDITOR'S PREFACE

The fifth edition of *The Private Equity Review* comes on the heels of a solid but at times uneven 2015 for private equity. Deal activity and fundraising were strong in North America, Europe and Asia, but the year ended with uncertainty in the face of declining growth in China, Brazil and other developing and emerging markets, increased volatility in commodity, stock, currency and other financial markets, and deflation concerns in developed countries. Nevertheless, we expect private equity will continue to play an important role in global financial markets, not only in North America and western Europe, but also in developing and emerging markets in Asia, South America, the Middle East and Africa. As large global private equity powerhouses extend their reach into new markets, home-grown private equity firms, many of whose principals learned the business working for those industry leaders, have sprung up in many jurisdictions to compete using their local know-how.

As the industry continues to become more geographically diverse, private equity professionals need guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. This review has been prepared with this need in mind. It contains contributions from leading private equity practitioners in 29 different countries, with observations and advice on private equity deal-making and fundraising in their respective jurisdictions.

As private equity has grown, it has also faced increasing regulatory scrutiny throughout the world. Adding to this complexity, regulation of private equity is not uniform from country to country. As a result, the following chapters also include a brief discussion of these various regulatory regimes.

While no one can predict exactly how private equity will fare in 2016, it can confidently be said that it will continue to play an important role in the global economy. Private equity by its very nature continually seeks out new, profitable investment opportunities, so its further expansion into growing emerging markets is also inevitable. It remains to be seen how local markets and policymakers respond.

I want to thank everyone who contributed their time and labour to making this fifth edition of *The Private Equity Review* possible. Each of them is a leader in his or her respective market, so I appreciate that they have used their valuable and scarce time to share their expertise.

Stephen L Ritchie
Kirkland & Ellis LLP
Chicago, Illinois
March 2016

Chapter 23

UNITED KINGDOM

Stephen Drewitt[1]

I OVERVIEW

i Deal activity

The UK private equity deal market performed very strongly in 2015 with the Centre for Management Buy-out Research (CMBOR) reporting the value of UK deals at €26.8 billion. This is a significant improvement on 2014's total of €21 billion, notwithstanding that 2014 was a good year for deal activity in its own right. While the number of UK deals recorded by CMBOR fell from 236 in 2014 to 197 in 2015, the UK market's performance was underpinned by the return of activity at the top end of the market.

In the context of the European market, the UK continued to lead the way and contributed materially to the significant levels of European private equity activity in 2015. CMBOR reported that 2015 saw the highest level of activity by value in Europe since the high watermark of 2007, with aggregate deal value reaching €80.9 billion.

Consistent with 2014, private equity sponsors were supported in 2015 by a number of factors that encouraged deal activity in the UK private equity market. Private equity sponsors continued to have access to significant levels of committed capital from their investors and debt markets remained open, accessible and willing to support private equity transactions. In addition, initial public offerings (IPOs) continued to offer private equity sponsors an alternative exit route to trade sales and secondary buyouts, albeit the UK IPO market did suffer periods of volatility in 2015 which, at times, negatively impacted the ability of private equity sponsors to realise investments by way of IPOs. At a macro level, the UK market also benefited from a level of political stability in

1 Stephen Drewitt is a partner at Macfarlanes LLP.

the second half of 2015. Parliamentary elections in May 2015 resulted in a majority government, thereby avoiding a 'hung' parliament and a related period of uncertainty that could have dampened economic activity in the UK.

ii Operation of the market

Management equity incentive arrangements

Managers are an integral part of most private equity investments, as they are the people on whom the sponsor relies to operate the business on a day-to-day basis. Making sure that the management team is properly incentivised and that its interests are aligned with those of the private equity sponsor – ensuring all are working towards a successful exit – are key considerations of any investment.

The form of equity incentive arrangements depends on a number of factors relating to the particular deal: for example, whether it is an auction process or a proprietary deal, the size of the sponsor's stake, the growth strategy for the business and the relative importance of a particular management team to the business. Sponsors are adopting a wide range of positions but, as a result of:

a the perception (in an active auction market) that relationships with management can play an important part in winning an auction process; and

b the increasing prominence of corporate finance advisers focused on advising management teams who have detailed knowledge of management terms available in the market, there is pressure on sponsors to move away from a 'house' position and towards a standard, more 'management friendly' position.

Despite this, it is possible to draw out some norms from the deals that have taken place over the past 12 months. It is still common for between 15 and 25 per cent of equity to be allocated to management, with the 75 per cent threshold for the passing of special resolutions often acting as a limit on the upper end of equity allocation. Management may sometimes benefit from a ratchet under which value is transferred from the investor strip to the sweet equity if certain internal rates of return and money multiple hurdles are met.

The traditional concepts of 'good leaver' and 'bad leaver' are still carefully negotiated by the sponsor and the management team. Sponsors typically accept that a good leaver is someone who leaves because of death, ill health or retirement, with persons leaving for any other reason being defined as bad leavers. A good leaver is likely to receive market value for his or her shares, with a bad leaver receiving the lower of market value and the investment cost. It is now commonplace for there to be an 'intermediate leaver'. Bad leavers are then limited to managers who resign or who are dismissed for gross misconduct, with intermediate leavers being managers who are dismissed for other reasons, but who are not good leavers. An intermediate leaver typically receives a blend of market value and the investment cost, with the blend changing as the period of his or her employment continues.

Sales processes

Private equity sponsors have continued to use competitive vendor auction processes in 2015 to exit their investments through sales to other financial investors or trade buyers.

However, a number of private equity sponsors have also been able to realise exits through IPOs. As a result (and consistent with 2014), private equity sponsors have, in certain circumstances, considered an IPO either as a stand-alone exit process or as part of a dual-track process alongside a traditional sales process. Blackstone's sale of Center Parcs for around €3.4 billion illustrates this approach, with Blackstone starting to work on an IPO, while concurrently running a competitive auction process that ultimately led to Brookfield Property Partners acquiring the UK holiday parks operator. In some circumstances, the possibility of a dividend recapitalisation was introduced to create a triple-track process.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

The basic structure through which private equity houses channel their investments has not changed in any meaningful sense over the past year. Structures involving four newly incorporated companies (newcos) are now relatively routine in order to accommodate the perceived need to structurally subordinate the various strata of shareholder and third-party debt. The decision as to the jurisdiction of incorporation of these newcos will be driven by tax-structuring considerations, although consideration should also be given to the practical implications of this decision, including the potential difficulties of a future exit at the level of a non-UK resident entity. Buyers are generally unwilling to acquire a non-UK tax-resident company unless suitable protection can be obtained against any risk of challenge to tax residency, either through direct warranties or via an appropriate insurance policy.

The key legal documents are the sale and purchase agreement and, to deal with an investor's ongoing relationship with management and any other minority investors, an investment agreement and articles of association of the company in which the shares are held. Key concerns for the investor will be to ensure that it has the right to receive regular financial information relating to the target business, including monthly management accounts, and has the ability to review and approve the draft budget for future financial years before it is adopted.

Whether or not the investor holds a majority position, it will require that neither the target group nor any of the managers are able to take certain actions relating to the business of the target group without the consent of the investor or the investor director. While the investor will wish to have sight of, and to be consulted on, certain business decisions, it is in the interests of neither the investor nor management for the materiality threshold to be set at such a level that the management team is not free to operate the business on a day-to-day basis. The precise rights given to the investor will therefore need to be carefully discussed on a deal-by-deal basis to ensure that the optimal balance is achieved between protecting shareholders and allowing efficient management of the business.

An investor will be concerned with ensuring that the documents properly contemplate any future exit and, in particular, that the investor will be able to offer up to 100 per cent of the company to a buyer. It will therefore require 'drag-along' rights enabling it to force other shareholders to sell their shares to a third party in the event that those other shareholders are not willing sellers; however, sponsors – and buyers – prefer consensual exits, and drag-along rights are generally only used as a last resort. In addition, investors are increasingly requiring management teams to sign up to lengthy exit provisions committing management to undertake a broad range of actions to facilitate an exit at the relevant time.

ii Fiduciary duties and liabilities

There are a number of scenarios in which a private equity investor might have cause to consider the fiduciary and statutory duties it owes to the other parties to an investment.

Duties owed by a shareholder

It is a basic principle of English law that a member does not owe any duty of care or other fiduciary duty to its fellow shareholders and may consequently exercise the right to vote its shares in any way it wishes. The only exception to this principle was introduced by *Allen v. Gold Reefs of West Africa*,[2] which concerned the right of the majority shareholders to change the articles of association so as to introduce compulsory acquisition provisions. The judge held that any resolution to alter the articles must be '*bona fide* for the benefit of the company as a whole'. What was not specified was whether, by 'the company as a whole', the judge was referring to the general body of shareholders or the company as a commercial entity distinct from the shareholders. This issue was addressed in *Greenhalgh v. Arderne Cinemas*,[3] where the judge held that '*bona fide* for the benefit of the company as a whole' means *bona fide* in the interests of the general body of shareholders. Consequently, until such time as this issue is dealt with by the Supreme Court or through the enactment of appropriate legislation, there will inevitably be uncertainty regarding the circumstances, if any, in which it is legitimate for majority shareholders to exercise their power to introduce compulsory transfer provisions into a company's articles.[4] This issue arises for consideration most regularly when, in the context of a particular exit, there is a question as to whether the drag-along provisions apply and it is proposed that changes be made to accommodate that particular exit.

Before attempting to implement any alteration to the share capital generally or the rights attaching thereto, a majority shareholder should consider whether such an alteration could also constitute an amendment to any class of shares held by the minority. For a variety of reasons, the sponsor and management will often hold different classes of shares. Where a proposed amendment will affect the rights attaching to a particular class of share, it cannot be approved except by the holders of a 75 per cent majority of shares in that class or in accordance with any specific provision set out in the articles of association of the company.

2 [1900] 1 Ch 656.

3 [1951] Ch 286.

4 David Chilvers QC and Ben Shaw, *The Law of the Majority Shareholder Power: Use and Abuse*, first edition, 2008.

Duties owed by a director

The Companies Act 2006 (2006 Act) codifies the fiduciary duties owed by directors under common law and sets out seven general duties of directors comprising duties:

a to act in accordance with the company's constitution and only exercise their powers for the purposes for which they are conferred;

b to act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole;

c to exercise independent judgement;

d to exercise reasonable care, skill and diligence;

e to avoid conflicts of interest;

f not to accept benefits from third parties; and

g to declare interests in proposed transactions or arrangements with the company.

The duties are cumulative in that they must all be complied with in any given set of circumstances. In practice, they are likely to overlap in many circumstances. They are described as 'general duties', which distinguishes them from other duties; for example, statutory duties under insolvency and health and safety legislation, which may apply in any given situation. The general duties are not exhaustive – compliance with them will not excuse any breach of any other duty imposed on directors by law or statute.

The general duties apply to all directors, by whatever name they are called. As such, they apply both to executive directors and also to directors appointed to the board of a portfolio company by the private equity investor. These investor directors are typically employees of the private equity house whose role on the board of the portfolio company is to monitor the sponsor's investment and to ensure that the company is adhering to the business plan and other performance criteria agreed with the private equity house. In this context, while all the general duties are relevant, the duties of directors to avoid conflicts of interest and to exercise independent judgement are of particular concern.

Section 175 of the 2006 Act requires directors to avoid situations in which they have, or can have, a direct or indirect interest that conflicts, or may possibly conflict, with the interests of the company for whom they act as director. Although there is no definition of 'interest' or 'conflicts of interest', it is generally accepted that being an investor director of a portfolio company is a potential conflict situation for the purposes of the 2006 Act. One example of a conflict that could arise is if the board is required to vote on a proposal to allot additional shares to the private equity investor. It is in the interests of the sponsor to subscribe for shares at as low a price as possible, whereas the company's interests are clearly best served by obtaining the highest price possible for the shares. This duty is not infringed if the relevant conflict has been authorised by the board of the company. The board is empowered to authorise a conflict of interests:

a automatically in the case of a private company incorporated on or after 1 October 2008, provided nothing in the company's articles invalidates it; or

b in the case of a private company incorporated before 1 October 2008, either:
- by incorporating the necessary authorities in the company's articles of association by special resolution; or
- by an ordinary resolution of the members that authorisation may be given by the board of directors (which is administratively simpler than amending the articles).

In the case of an acquisition effected using a newco, the articles should be drafted to ensure that the investor director will not be in breach of Section 175 of the 2006 Act by reason simply of being the private equity shareholder's representative on the board.

Section 173 of the 2006 Act requires directors to exercise independent judgement, and investor directors must be careful to ensure that, while having regard to the interests of the sponsor they represent, the decision regarding the way in which they exercise their powers is their own and is taken on the basis of their duties to the company, not the shareholder. It should be noted that a breach of this duty cannot be ratified by the board.

The Bribery Act 2010

There was considerable concern in the period before the Bribery Act 2010 (the Bribery Act) came into force, that Section 7 of the Bribery Act (dealing with the failure of commercial organisations to prevent bribery) might operate to make a private equity fund or manager liable for bribery taking place within the portfolio.

Section 7 provides that a relevant commercial organisation is guilty of an offence if a person associated with it bribes another person intending to obtain or retain business or a business advantage. A person is 'associated' with a commercial organisation if it performs services for or on behalf of that organisation, and Section 8 cites employees, agents and subsidiaries as examples of persons who might perform services for an organisation.

Notwithstanding the Section 8 reference to subsidiaries, there is a strong argument that portfolio companies should not be said to perform services for or on behalf of the funds or the manager (even where those portfolio companies are majority owned by a fund). Simply paying dividends to a shareholder is arguably not enough to constitute the performance of services.

Furthermore, a prosecutor would have to prove that the intention of a bribe paid by a portfolio company (or an employee, agent, etc., of a portfolio company) was to obtain or retain business or an advantage in the conduct of business for the funds or the manager (rather than for the portfolio company itself). Guidance issued by the Ministry of Justice is helpful in this regard:

> *Without proof of the required intention [to obtain or retain business or an advantage in the conduct of business for the funds or the manager], liability will not accrue through simple corporate ownership or investment, or through the payment of dividends or provision of loans by a subsidiary to its parent […] This is so even though the parent company […] may benefit indirectly from the bribe.*

It therefore seems very unlikely (but not impossible if, for example, a court were minded to interpret the legislation widely to make a high-profile example of a private equity house) that bribery in the portfolio company would give rise to any criminal liability for the funds that owned the portfolio company or the manager managing or advising those funds.

It should be noted, however, that a portfolio company is itself a person capable of committing offences under Sections 1, 2 and 6 of the Bribery Act (direct bribery offences). For criminal law purposes, the acts of those persons who represent the 'directing will and mind' of a company are deemed to be acts of the company itself. This concept clearly catches acts of directors, but also potentially other members of senior management. Investor directors must therefore satisfy themselves that the risk of any person who might constitute the 'directing will and mind' of a portfolio company giving or accepting bribes is low.

Of particular concern to investors is the recent activity of the Serious Fraud Office (SFO). In early 2012, the SFO for the first time obtained a civil recovery order against a shareholder of a company involved in historic bribery. The order was made under Part 5 of the Proceeds of Crime Act 2002 (POCA), which enables the SFO and other entities to trace and recover 'property obtained through unlawful conduct'. As a result, Mabey Engineering (Holdings) Limited was required to repay over £130,000 received by way of dividends from its subsidiary, Mabey & Johnson Limited, which was convicted of corruption offences and breaches of sanctions in September 2009. In addition, the SFO has taken action against Oxford University Press in respect of bribery in tenders in which certain of its subsidiaries were involved (which resulted in an order to pay around £1.9 million). The SFO took this approach, even though Oxford University Press had reported itself to the SFO, funded the SFO's investigation and voluntarily made a large donation to an educational charity in the relevant regions.

The SFO has stated that it 'intends to use the civil recovery process to pursue investors who have benefited from illegal activity', and has signalled an intention to tackle, in particular, 'institutional investors whose due diligence has clearly been lax' and who 'have the knowledge and expertise' to conduct appropriate levels of due diligence to satisfy themselves that the company in which they are investing is not involved in corruption. In some respects, this stated intention to hold shareholders responsible for their investment decisions represents an extension of the concepts contained within Section 7 of the Bribery Act, which, as discussed above, makes commercial organisations responsible for bribery undertaken by persons associated with them. The real concern, however, is that Section 7 allows for companies to defend themselves against offences of bribery, whereas POCA sets out a strict test for liability that is not affected by a person's behaviour – assets either derive from the proceeds of crime, and are therefore liable to be recovered, or they do not. It is therefore difficult to see how an investor could take steps to protect itself, however sophisticated its due diligence processes and whatever steps it took to monitor its investment.

III YEAR IN REVIEW

i Recent deal activity

2015 saw an active private equity market in the UK, which resulted in a strong full year performance and underscored the UK's position as a leading European market for private equity.

A particular feature of the UK's 2015 performance was the return of activity to the upper end of the market. With the occurrence of the New Look acquisition for around £1.9 billion, 2015 saw the first UK buyout with a value in excess of £1 billion since the third quarter of 2012. Other large private equity transactions in 2015 included the approximately €1.8 billion sale by CVC Capital Partners of Virgin Active to South

African private equity firm Brait, the sale by Hellman & Friedman of Wood Mackenzie to Verisk Analytics, Inc for around £1.85 billion and the sale by Permira of Iglo Group to Nomad Holdings Limited for approximately €2.6 billion.

In addition to the activity at the top end of the market, another highlight for the UK private equity market was the performance of the upper middle market. CMBOR reported that, by the end of the second quarter of 2015, transactions valued between £500 million and £1 billion had an aggregate value of £2.4 billion and had already exceeded the aggregate value of such transactions for the whole of 2014 (£2 billion). Such transactions include the public to private of Advanced Computer Software by Vista Equity Partners for £725 million and the sale by Sky of Sky Bet to CVC Capital Partners in a deal valuing Sky Bet at £800 million.

Notwithstanding the periods of stock market turbulence in the later stages of 2015, the flotation of private equity-backed companies on the public markets also helped to stimulate UK deal activity. Examples include the IPO of Auto Trader by Apax at a value of €3.3 billion and the €6.4 billion IPO of Worldpay by Advent and Bain (recorded by CMBOR as the largest exit of 2015).

The UK also remained an attractive market for foreign investors, particularly North American investors seeking exposure to European markets but with the perceived level of protection from eurozone risks provided by the comparative safety of the UK and its sterling currency. Transactions involving such investors included Warburg Pincus' sale of Survitec to Onex for £450 million, the sale by Charterhouse Capital Partners of Environmental Resources Management for €1.5 billion and the sale by Exponent Private Equity of Trainline to KKR & Co.

ii Financing

2015 saw further improvement in the availability of financing in the UK from both traditional sources and alternative lenders. In the leveraged loan market, bank club deals not subject to general syndication remained common in mid-cap bank financings, while arranger groups commonly appeared in larger underwritten deals at the upper end of the market.

Alternative direct lenders, such as insurers, pension funds in certain asset classes (notably real estate and infrastructure) and specialist debt funds (such as Hayfin, Ares Capital, GE, ICG, Babson, BlueBay and Five Arrows) have continued to see strong growth and have significantly increased their share of mid-market lending. Their loans are often structured as unitranche non-amortising term facilities (effectively a blended senior and mezzanine offering) coupled with a working capital facility from a bank lender. Unitranche lending dominated the mid-market at over 50 per cent of new leveraged financings and sponsors and corporate borrowers have become very comfortable with the product. Competition among lenders in the unitranche market has led to several key developments:

a a number of funds have formalised their relationships with bank lenders in order to offer a combined unitranche and super senior revolving facility product and streamlined execution;

b there has been increased flexibility in terms on offer to sponsors; and *c* 'bifurcated' unitranche structures have started to appear, where the bank lender will take a first-out piece of the unitranche at a lower margin and the debt fund will take a first-loss piece at a higher margin, regulated by an 'agreement among lenders' not typically seen by borrowers and resulting in a single blended unitranche margin being charged.

Mezzanine debt continued to feature in very few UK deals in 2015, although it was more commonly seen in continental Europe where unitranche has thus far made fewer inroads. New mezzanine borrowing decreased again versus 2014 (already down against 2013) and the popularity of unitranche in the UK in preference to mezzanine debt is now clear.

Second lien debt remained present in the upper market in 2015, occupying an equivalent position in the capital structure to high-yield bonds and was symptomatic of increased risk tolerance in 2015. It was used in buyout, refinancing and dividend recapitalisation structures.

The high-yield bond market is susceptible to investor sentiment around macroeconomic issues and consequently performed patchily for significant stretches of 2015. Bonds are usually used in acquisition financings (either bridged by undrawn bank facilities typically provided by the bond underwriters or funded by issuance directly into escrow pending acquisition close) and in bond-for-loan refinancings that also offer the prospect of sponsor equity returns. High-yield bonds typically form part of a bank-bond financing structure, with a super senior working capital facility provided by one or a small group of banks, often relationship banks. More recently there have been a number of loan-for-bond refinancings as high-yield bond spreads increased during the course of 2015 from around 500 basis points to around 800 basis points.

In 2015, borrowers also continued to access the liquidity in the US loan markets via hybrid cross-border European and US financing structures. These featured more frequently at the upper end of the market due to their complexity, in particular as a result of the differing expectations of US and European lenders as to security and intercreditor arrangements.

As far as legal terms for acquisition loan financings and refinancings were concerned, these eased at all levels of the market in 2015. All forms of loan debt continued to offer increasingly sponsor-friendly terms – more than 50 per cent of upper market leveraged financings were 'cov-lite' in 2015. 'Certain funds' and equity cure provisions continued as established features of European private equity financings and sponsors' counsel frequently drafted term sheets and provided first draft facility documentation. LIBOR and EURIBOR floors (whether at zero or above) featured less frequently in new loan facilities, although they remained a standard feature of US financings.

iii Key terms of recent control transactions

Key terms of private equity sale transactions remained largely unchanged in 2015, with private equity sellers focusing on the ability to return sales proceeds quickly to their fund investors and execution risk. Consequently, private equity sellers sought to limit their obligations and exposure under the transaction documentation and to avoid conditionality. Warranty insurance was a common way of limiting sell-side exposure while providing a buyer with meaningful recourse for breaches of warranty.

iv Exits

Exit activity in the UK has been buoyant in 2015 and the UK's performance helped the European exit market to reach a record aggregate exit value of €153.2 billion according to CMBOR.

Private equity sponsors were able to take advantage of a very active IPO market during the first two quarters of the year. The strong start to the year for this market was a stark contrast to the final months of 2014, during which a number of prospective flotations were cancelled. However, by the third quarter of 2015, volatility in the equity markets had stalled IPO exit activity by private equity sponsors. Notwithstanding this volatility, some private equity backed companies, such as Worldpay, were still able to complete significant public offerings by the end of 2015.

Trade sales and secondary buyouts also continued to provide private equity sponsors with exit routes for their investments and played an important part in the performance of the European exit market in 2015.

IV REGULATORY DEVELOPMENTS

i Overview of the current regulatory environment

Undertaking one of a number of specified 'regulated activities' in the UK requires authorisation by the UK Financial Conduct Authority (FCA) and, in some cases (principally related to insurance and accepting deposits), the Prudential Regulation Authority, unless an exemption is available.[5] Depending on the fund structure employed, a UK private equity sponsor is likely to undertake one or more of the following regulated activities:

a advising on investments;
b arranging transactions in investments;
c making arrangements with a view to such transactions;
d operating a collective investment scheme;
e managing investments; and
f managing an alternative investment fund (AIF).

UK sponsors therefore need to obtain FCA authorisation in order to carry out their investment activities.

The exact regulated activities that a particular sponsor may need to be authorised to undertake is dependent upon the precise scope of activities to be carried out in the UK. For example, where a UK sponsor utilises an offshore fund structure and does not have a discretionary investment management mandate in respect of the private equity fund or funds to whom its services are provided, it will not be treated as undertaking

5 Financial Services and Markets Act 2000 (FSMA), Section 19.

the regulated activity of managing investments. Instead, such a firm will be viewed as an 'adviser' or 'arranger' for regulatory purposes. Where a UK sponsor has a discretionary investment management mandate in relation to an AIF, it will undertake the regulated activity of managing an AIF and will be treated as an alternative investment fund manager (AIFM) operating under the EU Alternative Investment Fund Managers Directive (AIFMD).[6] If that sponsor decides to manage portfolios for clients other than AIFs, or provides additional non-core services, regulatory permissions will also be required in respect of those activities. Whether or not a regulated firm is subject to the European Markets in Financial Instruments Directive (MiFID)[7] has consequences for the detail of the compliance regime with which a firm must comply and, in particular, the amount of regulatory capital required.

Depending upon the facts, it is also possible that a non-UK sponsor may undertake regulated activities in the UK when engaging in UK transactions, although simply making a UK investment is unlikely, of itself, to bring such a sponsor within the UK regulatory regime.[8]

Many private equity sponsors have seen their regulatory obligations increase since 2013 as a result of the implementation of the AIFMD. The AIFMD imposes obligations on an EU manager of any AIF in one or more EU Member States and also restricts the marketing of funds. The AIFMD (among other requirements):

a imposes regulatory capital requirements;

b mandates the disclosure of certain key information to investors and regulators;

c requires the use of depositaries (essentially, custodians) to hold fund assets (i.e., interests in investee companies);

d imposes requirements in relation to remuneration – sponsors are required to adopt remuneration policies that promote sound and effective risk management and do not encourage risk-taking that is inconsistent with the risk profiles, fund rules or instruments of incorporation of the funds that the sponsors manage;

e restricts the outsourcing of key functions by managers, except where detailed outsourcing rules are complied with;[9] and

f requires registration of fund documentation with the relevant regulator.

Non-EU fund managers intending to manage EU AIFs must also become authorised and comply with the AIFMD.

Subject to transitional provisions (including, importantly, the continuation of the national private placement marketing regimes in the UK and certain other Member States for at least the short term), the AIFMD restricts the marketing of AIFs in the

6 Directive 2011/61/EU.

7 Directive 2004/39/EC.

8 The FCA has published guidance on the link between regulated activities and the UK in chapter 2.4 of the Perimeter Guidance sourcebook of the FCA Handbook (available at http://fshandbook.info/FS/html/FCA/). Section 418 of FSMA extends the ordinary meaning of 'in the UK' for these purposes.

9 Directive 2011/61/EU.

EU by sponsors based outside the EU, unless they comply with detailed 'third country' provisions. These require a non-EU manager to be regulated by a regulator that has signed a memorandum of understanding agreeing to impose certain requirements contained in the AIFMD on such investment managers (which includes compliance with substantially all of the AIFMD). However, AIFMs regulated under the AIFMD may make use of 'passport' rights to market EU AIFs across Europe, subject to complying with registration requirements.

The EU regulation on European Long Term Investment Funds[10] (ELTIFs) creates uniform rules on the authorisation, investment policies and ongoing requirements for EU AIFs that are managed by EU AIFMs authorised under AIFMD and marketed as ELTIFs. An ELTIF is a type of investment fund that enables professional and retail clients to invest in European companies and projects that require long-term capital. EU investment funds need to satisfy certain conditions to qualify as an ELTIF, including investing at least 70 per cent of their capital in eligible investment assets. There are specific marketing rules for the cross-border marketing of ELTIFs, which are in addition to the requirements set out in the AIFMD.

The UK regulatory regime also restricts the marketing of securities, which can potentially impact presentations issued or given in relation to transactions. A person may not issue a 'financial promotion' without being authorised, unless an exemption is available.[11] A 'financial promotion' is widely defined as an invitation or inducement to engage in investment activity, such as the buying or selling of shares or partnership interests.[12]

ii FCA authorisation process

An application for FCA authorisation should be made by the entity within a sponsor's group that will undertake regulated business in the UK. In order to become FCA authorised, a firm must submit an application in a prescribed form to the FCA.[13] A sponsor must also pay an application fee to the FCA.

Due to the level of detail involved in an application for FCA authorisation, sponsors frequently seek advice from external legal counsel and compliance consultants. In addition, many sponsors appoint a firm of accountants to advise them in connection with regulatory capital issues and to prepare the detailed financial forecasts that must be submitted as part of an application for FCA authorisation.

The FCA authorisation process can be lengthy, and is currently likely to take between five and nine months from inception to obtaining authorised status from the FCA, depending upon whether a sponsor is proactive in putting an application together and also the complexity of the sponsor's business (and structure) from a regulatory

10 Regulation (EU) 2015/760.

11 FSMA, Section 21.

12 Id.

13 The application form for FCA authorisation is available at www.fca.org.uk/firms/about-authorisation/authorising-soloregulated-firms.

perspective. Legally, the FCA has six months from the date on which an application that the FCA considers to be complete is submitted to it in which to determine an application (or 12 months from the date on which it receives an incomplete application).[14]

iii Ongoing obligations

As an FCA-authorised firm, a UK private equity sponsor is subject to a number of ongoing regulatory obligations that impact the way in which it runs its business and potentially the conduct of transactions. As part of these obligations, an authorised firm:

a must maintain 'regulatory capital' equal to or in excess of a figure determined in accordance with detailed rules (firms that are within the scope of MiFID must additionally undertake an 'internal capital adequacy assessment process' whereby the risks to which a firm is exposed are calculated);

b is required to put in place and maintain adequate senior management arrangements, systems and controls, in compliance with detailed FCA requirements;

c must comply with detailed record-keeping, reporting (both compliance and financial) and notification obligations, including an overarching obligation to disclose to the FCA appropriately anything relating to the firm of which the FCA would reasonably expect notice;

d is required to have in place monitoring systems to ensure continued compliance with the FCA's rules;

e is required to consider market abuse, insider dealing and anti-bribery issues;

f must maintain a policy to monitor and deter any conflicts of interest (from a transactional perspective, the most important consequence of this is that an authorised firm is under a duty to identify and adequately manage actual or potential conflicts of interest and to disclose such conflicts under certain circumstances);[15]

g is required to ensure that staff are competent to perform their roles; and

h must verify the identity of counterparties when entering into a new transaction or business relationship.

iv FCA consent to changes in control

Where a private equity sponsor purchases an interest in an investee group that itself contains one or more FCA-authorised firms, it must first obtain FCA consent for the transaction, unless the interest to be acquired is sufficiently small so as to avoid the sponsor becoming a 'controller' after the transaction. For these purposes, control is usually triggered by reference to a 10 per cent share capital or voting rights (or other significant influence) test, although for target firms not subject to MiFID or certain other EU Directives, the applicable threshold is 20 per cent.

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14 FSMA, Sections 55V(1) and 55V(2).

15 Chapter 10 of the Senior Management Arrangements, Systems and Controls Sourcebook of the FCA Rules.

v Forthcoming developments

The European Commission may adopt a delegated act in 2016 specifying the date when AIFMD marketing 'passport' rights will become available to some non-EU AIFMs and AIFs. The European Securities and Markets Authority (ESMA), which is responsible for carrying out country-by-country assessments and opining on appropriate jurisdictions in which to extend the AIFMD passport, has completed assessments of Guernsey, Jersey and Switzerland. ESMA is currently assessing a number of other jurisdictions, including Australia, Bermuda, Canada, the Cayman Islands, Hong Kong, the Isle of Man, Japan Singapore and the United States. If, as anticipated, the AIFMD marketing passport is extended to non-EU AIFMs in particular jurisdictions it is envisaged that marketing under national private placement marketing regimes will be phased out.

MiFID II[16] is scheduled to be transposed into Member States' national law by 3 January 2017, although it is looking increasingly likely that this implementation date will be delayed by a year. MiFID II includes provisions on:

a pre and post-trade transparency;
b the further regulation of the provision of investment services and trading venues;
c a tightening of execution, transaction reporting and investor protection obligations; and
d increased market intervention powers for regulators.

Although its impact is primarily focused on more liquid investment activity than private equity, MiFID II will impact the compliance framework of those private equity houses subject to MiFID.

It is expected that the Solvency II Directive (Solvency II),[17] which insurance firms had to implement from 1 January 2016, will also have an indirect impact upon many sponsors. Solvency II requires insurance firms to risk-weight their investments and only permits them to treat certain percentages of assets as capital, depending on the risk weighting attributed to the asset class to which such assets belong. For these purposes, private equity has been placed in an 'other equities' category, with a higher risk weighting than publicly quoted equities, although in certain circumstances, insurers may be able to adopt a 'look through' approach to enable them to treat a holding in a fund as a holding in the underlying assets (possibly leading to a more benign capital treatment). In the absence of structuring solutions, this is likely to have a knock-on impact on insurance sector investors' appetite to participate in the private equity asset class. Currently, ELTIFs also fall within the 'other equities' risk category, but there are proposals to amend the implementing Regulation[18] to give ELTIFs the same (lower risk) categorisation as equities traded on regulated markets.

16 MiFID II, published on 12 June 2014, comprises a revised MiFID (Directive 2014/651 EU) and Regulation (Regulation (EU) 600/2014).

17 Directive 2009/138/EC.

18 Regulation (EU) 2015/35.

Another issue on the horizon for some sponsors is the possible extension of the senior managers regime (SMR) to all UK authorised financial services firms from 2018.[19] It is proposed that the SMR will replace the current approved persons regime and will make it easier for the FCA to hold individuals personally accountable for regulatory breaches within their area of responsibility.

V OUTLOOK

Private equity activity in the UK should continue to be supported by a number of positive factors into 2016. These include:

a the availability of leverage on competitive terms;

b corporate M&A activity;

c the significant levels of dry powder committed to private equity funds by investors (both to historic funds and newly raised funds);

d pressure on private equity managers to dispose of assets and return capital to their investors ahead of fundraisings, so as to:
- demonstrate an ability to create and realise value for their investors; and
- free up capital for investors to allow investors to commit to new funds while staying within their asset allocation parameters (many investors depend on distributions from their private equity investments to fund a significant proportion of their commitments to new private equity funds); and

e the fact that the UK remains an attractive economy for international investors seeking a degree of exposure to the eurozone.

All of these factors and the performance of the UK private equity market in 2015 would suggest that the UK private equity market should be well positioned for 2016. However, notwithstanding these positives, the UK private equity market has the potential to be materially adversely impacted in 2016 by global economic and political instability, including as a result of problems in the Chinese and Russian economies, conflicts in the Middle East, the spectre of a British exit from the European Union, stock market volatility and the ongoing disruption to the oil markets.

19 HM Treasury paper: Senior Managers and Certification Regime: extension to all FSMA authorised persons (October 2015).

Appendix 1

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