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KIRKLAND **BRIEF**

October 2009

Regulation of Private Equity Firms: FSA Authorisation

1 INTRODUCTION

1.1 The provision of financial services in the United Kingdom is regulated by the Financial Services Authority ("FSA").

1.2 It is a criminal offence for a person to carry on a regulated financial services activity in the UK unless that person is authorised by the FSA.

1.3 Many of the activities carried on by private equity firms will be regulated activities, so a private equity firm will usually need to be authorised by the FSA in order to operate in the UK.

1.4 Once authorised, a private equity firm will be required to comply with the FSA Handbook of Rules and Guidance (the "FSA Rules"). The FSA Rules include high level standards that apply to all authorised firms, detailed provisions governing the day-to-day operation of the firm's business and regulatory capital requirements.

1.5 The provision of certain financial services is also regulated at the European Union level. In some circumstances, the rules to which a firm is subject will depend on whether or not the activities carried on are regulated by EU law.

2 WHERE ARE THE RULES FOUND?

2.1 The main UK Act of Parliament is the Financial Services and Markets Act 2000 ("FSMA").

2.2 However, FSMA is a framework Act only, and much of the detail is found in subordinate legislation. Key statutory instruments include:

a) Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, as amended (the "RO"); and

b) Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (the "CIS Order").

2.3 All authorised firms are subject to the FSA Rules, which can be found on the FSA website at http://fsahandbook.info/FSA/html/handbook/. Key EU legislation and related documents are also available from the FSA website (http://www.fsa.gov.uk/).

3 REGULATED ACTIVITIES

3.1 An activity is a regulated activity for the purposes of FSMA if it is:

a) an activity of a specified kind;

b) which is carried on by way of business; and

c) relates to an investment of a specified kind.

3.2 The relevant activities and investments are specified in the RO. The activities and investments likely to be relevant to private equity firms include:

Activities

- Dealing in investments as agent (Article 21 RO)
- Arranging deals in investments (Article 25 RO)
- Managing investments (Article 37 RO)
- Safeguarding and administering investments (Article 40 RO)
- Establishing, operating or winding up a collective investment scheme (Article 51 RO)
- Advising on investments (Article 53 RO)
- Agreeing to carry on regulated activities (Article 64 RO)

Investments

- Shares (Article 76 RO)
- Debentures and other loan stock (Article 77 RO)
- Warrants (Article 79 RO)
- Options (Article 83 RO)
- Futures (Article 84 RO)
- Contracts for differences (Article 85 RO)
- Units in a collective investment scheme (Article 81 RO)

3.3 When considering the regulated activities that will be carried on by a private equity firm, it is important to take into account everything that the firm does. For example, if a firm plans to hedge currency risk for its funds, then its scope of permission will need to extend to derivative instruments even though such instruments may not form part of the firm's general investment strategy.

3.4 Certain activities are excluded from the definition of a "regulated activity". For example, intra-group activity is excluded in some circumstances. As it is a criminal offence to carry on regulated activities without FSA authorisation, if a firm proposes to rely on an exclusion, it is necessary to undertake a detailed assessment of the activities to be carried on to ensure that the conditions of the exclusion are met.

4 BECOMING AN AUTHORISED PERSON

4.1 To become an authorised person, a firm must apply to the FSA under Part IV of FSMA for permission to carry on one or more regulated activities.

4.2 In making its application, the firm must demonstrate that it meets the threshold conditions for authorisation. These are that:

a) If the firm is a body corporate constituted under UK law (for example, a UK limited company or limited liability partnership), its head office and its registered office (if any) must be in the UK. If the person concerned has its head office in the UK but is not a body corporate, it must carry on business in the UK. (This is a requirement of EU law.)

b) If the firm has close links with another person (that is, there is a parent, subsidiary or "sister" company relationship, or ownership or control of more than 20% of voting rights or capital by or in that other person), the FSA must be satisfied:

   (i) that those links are not likely to prevent the FSA's effective supervision of the firm; and

   (ii) if it appears to the FSA that the other person is subject to the laws, regulations or administrative provisions of a territory which is not an EE State, that neither the foreign provisions, nor any deficiency in their enforcement, would prevent the FSA's effective supervision of the firm.

c) The resources of the firm must, in the opinion of the FSA, be adequate in relation to the regulated activities that it seeks to carry on. This includes both financial and non-financial resources.

d) The firm must satisfy the FSA that it is a fit and proper person to be authorised having regard to all the circumstances, including:

(i) its connection with any person;

(ii) the nature of any regulated activity that it seeks to carry on; and

(iii) the need to ensure that its affairs are conducted soundly and prudently.

4.3 The information to be provided by the firm in its application include:

a) details of the regulated activities which the firm proposes to carry on;

b) a staff organisational chart, showing the firm's management structure and reporting lines;

c) business plan information, such as the firm's background, location, clients, target market, marketing plan, personnel and internal controls;

d) a compliance monitoring programme;

e) details of the firm's professional advisers;

f) a monthly profit and loss forecast for the first year of trading;

g) a monthly cashflow forecast;

h) a monthly forecast of the firm's regulatory capital versus regulatory capital requirements for the first year of trading;

i) a monthly balance sheet forecast for the first year of trading;

j) a copy of the latest annual accounts (if the firm has previously traded); and

k) proof of the firm's capital.

The FSA has the right to ask for such further information as it reasonably considers necessary to enable it to determine the application, and may also require a firm to verify the information provided.

4.4 The firm must pay an application fee, which varies with the complexity of the application. If the firm will establish, operate and manage a fund in the UK, the application will be "moderately complex" and the fee will be £5,000. If the firm's activities in the UK will be limited to advising on investments and arranging transactions, the application will be "straightforward", and the fee will be £1,500.[1]

4.5 The FSA has a statutory period of six months in which to determine an application for authorisation, which runs from the date on which the FSA receives the completed application (that is, one which includes all necessary information). In practice, applications are usually determined in a much shorter period, although it is advisable to submit the application at least three to four months before the firm intends to start carrying on regulated activities.

4.6 If authorisation is granted, the FSA will write to the firm confirming its authorisation and enclosing the firm's "scope of permission notice." The scope of permission notice will specify the activities that the firm is permitted to carry on, and may also include certain limitations and requirements. For example, a private equity firm may be limited to carrying on business only with non-retail customers, or be subject to a requirement that it carries on venture capital business only. These limitations and requirements may be applied for by the firm, or imposed by the FSA on its own initiative.

4.7 Once authorisation has been granted, the firm is expected to start carrying on regulated activities in line with its regulatory business plan within 12 months. If it does not do so, the FSA may vary or cancel the firm's permission.

5 THE APPROVED PERSONS REGIME

5.1 FSMA requires individuals performing certain roles, known as "controlled functions", within an authorised firm to be approved in advance by the FSA. The controlled functions most commonly applicable to private equity firms are:

Governing functions

CF1 Director function

CF2 Non-executive director function

CF3 Chief executive function

CF4 Partner function

Required functions

CF8 Apportionment and oversight function

CF10 Compliance oversight function

CF11 Money laundering reporting function

Customer functions

CF30 Customer function

5.2 The firm must indicate in its application for authorisation which individuals will be performing these functions, and must demonstrate that they are fit and proper to do so. In assessing fitness and propriety, the FSA focuses primarily on:

- honesty, integrity and reputation;
- competence and capability; and
- financial soundness.

6 COMPLIANCE WITH THE FSA RULES

6.1 Once a firm is an authorised person, it is required to comply with the FSA Rules insofar as they apply to the regulated activities carried on by the firm.

6.2 All authorised firms are required to comply with the FSA's high-level Principles for Businesses. These are that:

- A firm must conduct its business with integrity
- A firm must conduct its business with due skill, care and diligence
- A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems
- A firm must maintain adequate financial resources
- A firm must observe proper standards of market conduct
- A firm must pay due regard to the interests of its customers and treat them fairly
- A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading
- A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client
- A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment
- A firm must arrange adequate protection for clients' assets when it is responsible for them
- A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice

The FSA takes a "principles-based" approach to regulation, which means that a firm may be subject to FSA enforcement action for breach of a principle even though it has not breached any specific rule.

6.3 Authorised private equity firms will also be subject to rules governing:

- Senior Management Arrangements, Systems and Controls ("SYSC")
- Conduct of Business ("COBs")
- Client Assets ("CSS")
- Market Conduct ("MR")
- Training and Competence ("TC")

Approved persons are additionally subject to:

- The Fit and Proper test for Approved Persons ("FIT")
- Statements of Principle and Code of Practice for Approved Persons ("APER")

6.4 It is important that all personnel are aware of, and comply with, these regulatory obligations. The FSA has a number of sanctions available if firms breach the rules, including public censure, financial penalties, prohibiting individuals from performing controlled functions and varying or cancelling the firm's permission.

7 REGULATORY CAPITAL

7.1 All authorised firms are required to maintain a certain level of regulatory capital. The amount of regulatory capital that a firm is required to maintain depends on whether the firm is subject to the re-cast Capital Adequacy Directive (EU legislation that imposes regulatory capital requirements for certain financial services businesses) (the "CAD"). A full analysis is beyond the scope of this briefing note, but some of the most common situations are discussed below.

7.2 A firm that operates and manages a private equity fund in the UK will be entirely exempt from the CAD (provided that it does not carry on other activities unrelated to its fund management). The regulatory capital requirement for this type of firm will be £5,000, provided that the firm is permitted to hold client monies or assets, and to arrange deals in investments, only in respect of venture capital investments for non-retail customers.

7.3 A private equity firm that does not operate and manage a fund in the UK, but arranges deals in investments and provides investment advice (typically to an offshore or other non-UK fund), will also be exempt from the CAD, provided that it is not permitted to hold client monies, to safeguard and administer assets, or to carry on other regulated activities that would bring the firm within the scope of EU regulation. However, this type of firm does not benefit from the £5,000 regulatory capital requirement, but will instead be required to hold €50,000 of regulatory capital (or alternatively to have professional indemnity insurance cover for at least €1,000,000 per claim and €1,500,000 for all claims in a year).

7.4 A firm that carries on a wider range of activities than those described above will generally be subject to a higher regulatory capital requirement.

1 Fees correct as at October 2009

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