Regulatory Update: Impact for Private Equity Houses under the new regime

2 July 2003
Agenda

- Introduction and welcome – Angela Crawford-Ingle
- FSA Risk Assessment Framework – Stephen Burke
- Money Laundering – Sian Herbert
- Limited Liability Partnerships – Laura Cox
- Discussion
Agenda

- FSA risk assessment framework, the key risks and concerns for private equity firms
- Thoughts on FSA rules in the context of private equity
  - Senior Management Arrangements, Systems and Controls
  - Training and Competence
  - Prudential Sourcebook
- FSA’s wish list!
Risk Mitigation Process

- Authorisation: ‘Gatekeeper’
- First cut: Impact metrics – FUM / Client assets / Commitments/Customer type
- Private Equity firms – ‘C’ & ‘D’
- C firms only subject to Risk Mitigation Process
- Discovery visit: high-level review of senior management and compliance arrangements
- Overall assessment: Impact v Probability - Risk Groups/Risk Elements; action; & period of assessment
- ‘Housekeeping issues’
Risk Mitigation Points: PI and IM Firms

Regulatory Update

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FSA themes and frequency

RISK MITIGATION THEMES

[Bar chart showing frequency of themes]

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FSA supervision for low impact firms

- Desk based monitoring
- Event driven
- Limited on site
- Low impact does not mean ‘no supervision’
FSA regulatory risk for Private Equity firms

- Continuing to meet Threshold Condition (especially 4 - Adequate Resources)
- Senior Management Arrangements, Systems and Controls (‘SYSC’)
- Risk based management and monitoring structures
- Anti-Money Laundering
- Business Continuity
FSA business concerns over Private Equity firms

- Economic situation: Raising funds/exits and investment more difficult
- Closure risk-Finite life cycle of funds
- Valuation of assets: ‘cosmetic valuations’ & syndicated investments
- Non-adherence to ‘terms and conditions’
- Co-investment: ‘cherry picking’ and classification of customer
- Regulatory capital management- charging expenses to administration company
Future Regulatory / Industry Developments

• The introduction of US style Small Business Enterprise Companies

• Consultation Paper 173 – Consolidated Supervision: ‘No consolidated deficit’/ leveraged investment in financial services firms.

• Consultation Paper 97 – Integrated Prudential Sourcebook June 2001
Senior Management Arrangements, Systems and Controls

Evidence of formal apportionment by the Oversight and Apportionment Controlled Function (CF8) and board approval of documentation covering:

- Identification of key business/regulatory risks and monitor plans
- Regulatory role profiles picking up key risks
- Group structure and organisational charts
- Term of reference of Committees and Departments

Regular re-review and validation
Training and Competence Assessment

- Identify all the positions in the firm subject to T&C
- Document the competency criteria for the role
- Map individuals against criteria and identify and address any gaps (experience and exam requirements)
- Grandfathered?
- Exam requirements?
- FSA individual experienced based waiver?
- Formally sign-off T&C competency for each individual
Training and Competence Maintenance

- Document structured and unstructured ongoing T&C requirements (reading industry journals, giving presentations, attending courses)
  - Technical knowledge and its application
  - Skills – their application and development
  - Changes in the market to products, legislation and regulation
- Complete annual training records for all staff
- Appraisal and sign off of competency
- Annual fitness and properness confirmation
Capital Requirement – Category 5B
(e.g. Non-ISD Venture Capital Firm)

Higher of:

Base Requirement £10,000
Or
Income Based Capital Requirement

• 5% of annual average income (including gains) for past 3 years
• Often leads to higher capital requirements
• Not final!

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Other issues

- Frequency of customer asset reconciliation's-where custodians used
- Frequency of reconciliation of “Custody assets”
- Custody statements extended from 25 business days to 90 days
- Application of daily client money calculation
FSA ‘Wish List’

- Completion of correct regulatory forms (e.g. waivers, Approved Persons)
- Provision of information as required by sourcebook
- Timely submission of regulatory returns
- Maintain adequate and appropriate internal control framework
- Take more part in influencing the regulatory agenda!
Anti Money Laundering
Sian Herbert
2 July 2003
Overview

• Understanding the Regulatory Environment
• Current Issues
• Future considerations
• Summary
Understanding the Regulatory Environment

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What is Money Laundering?

• “the process whereby criminals attempt to hide and disguise the true origin and ownership of the proceeds of their criminal activities, thereby avoiding prosecution, conviction and confiscation of the criminal funds.”

• Money laundering is not the same as fraud.
  – Fraud involves the loss or disappearance of assets or revenue; whereas
  – Money laundering involves the movement of large quantities of illicit proceeds
  – However, the movement of the fraudulent funds may involve an element of money laundering
The Traditional Money Laundering Triad

**Placement**
Cash is converted to monetary instruments or is deposited into accounts

**Layering**
Funds are moved to other FS institutions to obscure origins.

**Integration**
Funds are used to acquire legitimate assets or fund activities.
Regulated v. Unregulated

**All persons and entities**

- The money laundering offences
  - Assistance, concealment etc.
  - Tipping off
  - The Proceeds of Crime Act

**Regulated entities**

- The Money Laundering Regulations
- The FSA Rules
- The JMLSG Guidance Notes
Understanding The Regulatory Regime

Primary Legislation

International Pronouncements

Money Laundering Regulations

JMLSG Guidance Notes

FSA Rules
The Impact of Money Laundering

Reputational Risk

Risk of financial crime

Regulatory risk
Current Issues
Who Is the Customer?

Investor - Investment

- Limited Partner 1
- Limited Partner 2
- Limited Partner 3
- Fund Manager
- Placing Agent
- General Partner

Investment - Market

- Purchaser
- Investee Company
- Funder
- Venture Capital Fund
- Investment Advisor

Ultimate responsibility for verification
Reliance may be placed on others to verify
Verification activity may be delegated
Legal counter party
Senior Management AML Responsibilities

- Establish clear responsibilities and accountabilities
- Establish AML policies, procedures and controls
- Introduce staff training programmes
- Appoint an MLRO of sufficient seniority and competency who prepares an Annual Report/reports STRs
- Ensure compliance with the FSA Sourcebook
Future Movements

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Future Movements

- Regulatory developments
- Current customer review
- KYC convergence
- Financial crime
Summary
Can You Answer the Following Questions? …

- Do you know the AML risks for your organisation? Has this been documented?
- Are there adequate resources in the AML function?
- Do senior management consider the annual report and act on it?
- Has the impact of recent and forthcoming legislation been adequately assessed?
- Has the process and cost of the likely current customer review been considered?
- Do acquisition strategies include a consideration of AML risk?
Limited Liability Partnerships
Laura Cox

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Limited Liability Partnerships

- Uses in private equity fund structures
- LLP Characteristics and Members
- LLP Agreements
- Converting to LLP status
- Advantages over Limited Companies
Private Equity Fund Structures

- In typical UK private equity structure, the LLP would be used as the UK Investment Advisor
- FSA registered
- Operates under an investment management agreement with the GP of the Fund
- Key management are “members” rather than shareholders or employees
- Executives receive profits and drawings as members instead of salary
Limited Liability Partnerships

- New form of corporate vehicle (“body corporate”)
  - Limited Liability Partnerships Act 2000
  - Limited Liability Partnerships Regulations 2001
  - Companies Act 1985
- Registered with Companies House
- Files annual return and annual accounts
- Must be a “for profit” venture (any trade or business)
Members of LLPs

- One layer of management – the members
- Required to have at least 2 members (including 2 “Designated members” who will have certain powers and statutory responsibilities for running LLP)
- Disclosure of members’ names and addresses required
- Members can be individuals or legal entities
- No age, qualification or residency restrictions
- No minimum size or capital adequacy requirements
Members of LLPs

- Members are all agents of the LLP but not for each other
- Person can be a member and an employee of LLP
- Person disqualified under Directors Disqualification Act 1986 cannot be a member
- A bankrupt cannot participate in the formation, promotion or management of an LLP
- On insolvency, members can have liability for preferences or wrongful trading (like a shadow director)
LLP Powers

- Same as limited company
- Able to contract in own name
- Able to borrow and charge its assets
- Can sue and be sued
Forming the LLP

- Choose a name and consider protecting it during formation process
- Name must include words “LLP” or “limited liability partnership” and not be in use by any other company or LLP
- Simple form to be filed at Companies House
- Until LLP agreement is signed, members’ relationship is governed by statutory provisions
LLP Agreement

- Private agreement between members
- Capital structure
- Calls on capital
- Admission of members
- Ownership percentages
- Sharing of profit and losses
LLP Agreement

- Compensation of members
- Benefits and “employment” type rights (e.g. Pensions, holidays, health care, insurance, maternity)
- Voting rights
- Indemnity
- Exits (removal, resignation, etc) of members
Converting to LLP Status

• Process
  – Set up a new LLP and transfer the business and assets across from limited company to LLP

• Asset Transfer
  – Identify and confirm ownership of all business assets
  – Valuation of assets may be needed
  – Consideration given for transfer
  – Stamp duty issues
  – Procedure for asset transfer
Converting to LLP Status

• FSA
  – Notice to FSA re conversion
  – Revise business plan
  – Approval of members as “controllers”
  – Will not usually be viewed as a new authorisation application
  – 4 – 6 week process
Converting to LLP Status

• Employment issues
  – Resignation of employees who will be members
  – Loss of employment rights and assumption of liability by new members
  – TUPE and other rights of existing employees
  – Pension and other employee benefit arrangements
Converting to LLP Status

- Contracts with Third Parties
  - Assignment or novation of agreements
  - Third party consents sometimes required
  - Mortgages, charges and other encumbrances over assets may restrict transfer

- Business insurance
  - Transfer of existing insurance policies to LLP or obtain new coverage
Advantages

• Tax Advantages over Limited Companies
  – Tax transparent
  – No NIC paid by LLP in respect of payments to members (because they are not employees)
  – Members can take drawing from the LLP outside the tax regime
  – Tax payment is better from cash flow perspective. Tax due is paid in 3 instalments (time deferral benefit to members compared to PAYE)
  – No PAYE tax issues re benefits provided to members.
  – Members can claim Business Assets Taper Relief on qualifying assets held through LLP
Advantages

- Tax Advantages over Limited Companies
  - Lower risk that carried interest returns will be taxed under Schedule E (no employment link re services provided to the Fund)
  - No risk of “dividend trap” because LLP is not reliant on realised profits to pay out cash to members
  - Members may be able to use losses of LLP
  - LLP must be VAT registered and recover input VAT to extent it exceeds output VAT. The LLP can be VAT grouped with the GP of the Fund, so no VAT is charged on advisory fee
• Tax Disadvantages
  - No corporation tax deduction for salaries of members (and related PAYE and NIC costs) and loss of tax relief on employer’s NIC
  - LLP members will be required to pay NIC Class 2 (flat weekly rate £2) and make Class 4 contributions (7% on LLP profit share), but will save on employee’s NIC
  - Each member will be required to file a self assessment, together with a partnership tax return detailing the allocation of profits to its members
  - Profits of LLP may be taxable at a higher effective rate of tax, as brought into tax under personal tax (not corporation tax) rules
Other Advantages

- Liability protection
  - Corporate form with separate legal personality
  - Limited liability protection – should be equivalent to a company
  - Member’s personal liability is limited to their agreed capital contribution
  - Members are not liable for LLP’s negligence (or each others)
Other Advantages

- Flexible capital structures
  - Capital contributions set out in LLP agreement
  - Capital contributions can be amended by agreement of members
  - Easier to amend profit sharing ratios
  - No “dividend trap” situations arise
  - Less regulatory capital: overall the LLP has a lower cost base than comparable corporate vehicle and no tax provision is booked on the LLP’s balance sheet
Other Advantages

- Management freedom
  - Restrictions on corporate directors are not applicable:
    - Duty to have regard to employee interests
    - Disclosure of personal dealings with company
    - Limitations on and disclosure of service contracts
    - Restrictions on substantial property transactions
    - Restrictions on loans to directors
Other Advantages

• Management Freedom
  – Management structure that suits business can be implemented
  – Use of Key Man, Managing Member, Committees
  – Easier to deal with new joiner and good and bad leaver arrangements
"Relax, someone will be looking for us ... the Inland Revenue ... the FSA ... the TV licensing people."