BVCA GUIDES

Guide to
Fund Restructurings

Supported by RPC

Contents

Foreword

Welcome to the BVCA *Guide to Fund Restructurings*, produced with the support of RPC.

The topic of fund restructuring is one people like to avoid discussing yet it is one which absolutely needs to be addressed. Whilst not all restructurings are a consequence of something going wrong – GP-led secondaries are not uncommon, for example, as a way of managing liquidity – it remains a fact of life that things do not always go according to plan. Whether this be because of macro-economic factors impacting the investment strategy or fund performance, disputes between the GP and LP or a problem at the LP end, a restructuring can sometimes be required.

The purpose of this guide is to provide you with an overview of some of the most likely scenarios surrounding the need to restructure a fund and considerations on how they can be dealt with. At the risk of stating the obvious, a fund restructuring is a rather complicated business, and it is to RPC's credit that within these pages that have successfully managed to explain the pertinent issues in such an accessible and digestible manner.

As such, many thanks to Anthony Shatz, Partner and Head of Investment Funds at RPC, and his team for the hard work put into this guide.

September 2017

Tim Hames
Director General
BVCA

Introduction

Much is written about the legal, taxation and regulatory aspects of setting up a new investment fund, but less airtime is spent considering how to navigate the difficult legal issues that can arise where something does not go quite to plan in the management or operation of a fund, or where a fund has to be restructured in some way.

Two years ago, we authored a guide on the legal, tax and regulatory aspects of setting up a real estate fund (https://www.bvca.co.uk/Media-and-Publications/Guides/Fund-Strategies). In this guide, we consider and analyse the following restructuring scenarios:

- Brexit;
- a restructuring driven by under-performance of the fund;
- there is a dispute between the LPs and the GP;
- an LP defaults on its financial and/or other commitments to the fund;
- a dispute arises between or within the management team; and
- the manager undergoes an insolvency or quasi-insolvency event.

This guide also includes a section analysing the key liabilities and defences for asset managers in the (hopefully unlikely) event they get sued. For further context, we have included two appendices that contain summaries of:

- the Senior Managers and Certification Regime, which is due to be extended in its application to all FCA regulated firms; and
- the key findings of the FCA in its investigation into the asset management sector, which was published on 28 June 2017.

These summaries are evidence of an increasing regulatory focus on the asset management sector generally, of which private equity and other closed ended funds form a significant part.

The analysis set out in this guide assumes the fund is a closed-ended vehicle - with an investment mandate in private equity, real estate, infrastructure or debt - as opposed to open-ended retail funds or hedge funds.

This guide is intended for general information purposes only. Whilst every effort has been made to ensure that the contents of this guide accurately reflect the landscape as of September 2017, this guide does not constitute legal advice and the contents of this guide may be subject to revisions over time.

We very much hope you find this guide informative and illuminating.

The RPC Funds Team
September 2017

Restructuring Scenarios

Brexit

The UK is scheduled to leave the EU on 29 March 2019. Whilst that date is fixed, every other aspect of Brexit is uncertain. The publication of the European Council's guidelines for Brexit negotiations, which followed the Prime Minister's letter to Donald Tusk triggering Article 50, has provided some clarity, but plainly there are still a huge number of issues to work through and find common ground on.

Consequently, in the period up to 29 March 2019, the UK government will face a significant challenge in both agreeing the 'divorce settlement' and then putting in place a trade agreement with the EU to cover the UK's future trading relationship with the 27 remaining member states of the EU.

It is unlikely that all this will be agreed prior to the official leave date, which means there will be significant pressure on the UK government to ensure there are transitional measures in place for a few years post-Brexit. The substance of any transitional arrangement is at present impossible to predict.

Even if a transitional deal can be agreed, it is highly unlikely that UK fund managers will continue to have access to the single market as they do currently. The government has indicated it does not wish to remain a member of the single market but wishes to retain access to the single market. By contrast, the EU has been clear that there can be no 'cherry-picking' between the four fundamental freedoms that underpin the EU. In the light of the foregoing, it seems prudent to start planning for a 'hard Brexit' for those fund managers who would like to take advantage of the ability to operate cross-border within the EU under the Alternative Investment Fund Managers Directive (AIFMD).

AIFMD

The AIFMD introduced a harmonised regulatory framework across the EU for managers (AIFMs) of alternative investment funds (AIFs). The AIFMD applies directly to AIFMs and only indirectly regulates the AIFs which those AIFMs manage.

The location of the AIFM and the AIF (EU or non-EU) has a considerable impact on the effect of the AIFMD. Very broadly, the AIFMD requires AIFMs whose regular business is managing AIFs to be authorised or registered in their home member state. UK-based AIFMs are subject to both conduct and prudential regulation by the FCA.

Key issues

The impact of Brexit on fund managers will depend on the extent to which they are UK, EU or non-EU focused and the types of products they offer to investors. The extent of the impact also largely depends on whether exit from the EU is a 'hard' or 'soft' Brexit. A hard Brexit would result in the UK leaving Europe's single market. In these circumstances, the key issues for the UK asset management sector will be to seek to address:

- loss of the passporting rights granted by the AIFMD which allows AIFMs to market funds across the EU;
- loss of the ability to hire EU workers and therefore a loss of talent. The fund and asset management sector relies on the UK remaining open and attractive to global talent;
- loss of assets being kept in the UK. One of the biggest concerns flagged by the Investment Association is the potential for mainland European clients to "repatriate their asset management activity within the EU" once Britain has formally left the EU economic bloc; and
- the risks of changes to delegation rules enabling AIFMs to delegate to a UK-based investment manager.

One of these key concerns is that UK firms would lose managing and marketing rights into the EU. There is potentially a third-country passport regime under AIFMD which may enable a UK full-scope AIFM to have the benefit of the AIFMD marketing passport for marketing to professional investors in the EU.

However, the European Securities and Markets Authority (ESMA) is still working on its assessment of this application of the passport to non-EU countries, and if the current fractious climate continues it seems unlikely that there will be any pressure on ESMA to accelerate any assessment of the UK (particularly as some of the remaining EU countries will be keen to 'take business' from the UK). Depending on the ultimate timing and terms of Brexit, UK fund managers could well find themselves unable to use this AIFMD third-country passport.

Loss of passporting rights under the Markets in Financial Instruments Directive (MiFID) would similarly be a key issue. Many UK fund managers use a MiFID passport to undertake services in other EU member states, including portfolio management. The new rules that will be introduced by MiFID II (which comes into force before Brexit, in January 2018) will see a new EU-wide regime for third-country MiFID services, including portfolio management. It will be important to determine whether the UK will fall under this harmonised regime for third-country access to enable passporting to professional clients in EU member states.

Although third-country party rights are theoretically possible under both AIFMD and MiFID II, there is a political risk that individual member states and EU institutions may adopt a protectionist response to the first exit of a member state in a desire to uphold the interests of member states and discourage others from leaving the single market. This could undermine efforts to further develop the equivalence/third-country party regimes for non-member states. Conversely, there may be reasons that prompt the EU to reform its rules by streamlining the current complex rules regarding its interaction with non-member states.

Impact on AIFMs

Absent a settlement with the EU, UK AIFMs managing an EU AIF will lose their EU passporting rights. In this scenario, a UK AIFM that wishes to market its funds in the EU would have the following options:

- rely on the local national private placement regime (NPPR) or reverse solicitation. If equivalence is not granted for any reason UK managers may find they are required to apply for local licences in each country;
- opt to delay its marketing until the UK is evaluated and approved by ESMA for purposes of marketing into the EU. Commercial and timing reasons are likely to make this option unviable;
- a third option may involve using an AIFM within the EU, with delegation of some aspects of the fund management activity to the UK sub-AIFM, or a UK-based adviser. In this scenario it is important to keep within the limits of what AIFMD permits by way of sub-delegation and to ensure that the EU AIFM has the requisite substance and infrastructure to satisfy applicable regulatory requirements; or
- consider moving all main operations to a European Economic Area (EEA) jurisdiction in order to qualify for a passport.

Non-EU AIFMs managing non-EU AIFs not

currently marketing in or from the UK will by definition not be directly affected by Brexit, and will continue to market on the basis of NPPRs.

Establishing in another EU jurisdiction

The third option highlighted above is likely to be the most attractive for many affected firms. A substantial number of UK-based fund managers already use AIF platforms in Luxembourg and Ireland for pan-European distribution. Furthermore, many AIFMs have significant cross-border operations within the EU (and hence are comfortable with operating in certain jurisdictions). This is in part because AIFMs are permitted to delegate investment and risk management functions, though it should be noted that 'letterboxing' is prohibited (this is where an AIFM delegates so much of its function that the regulated AIFM would be deemed a 'letterbox' entity, whilst crucial decision making is made by an unregulated entity).

ESMA has published an opinion in which it outlined nine principles regarding the management and control of investment structures. In particular, ESMA made it clear that EU-based entities should not simply become letterbox entities, which could lead to barriers to effective supervision and enforcement.

Some UK AIFMs are now looking at establishing a legally distinct subsidiary in, for instance, Luxembourg. In general terms subsidiaries have to obtain individual authorisation to be permitted to undertake relevant regulatory activities, whilst branches of a firm established in another member state can rely upon passported permissions from the parent entity. In addition to those UK AIFMs that are seeking to establish themselves in Luxembourg, there are also a number of US firms who are 'Brexit proofing' themselves by establishing parallel funds in the UK and Luxembourg. In both cases, where AIFMs are being set up in Luxembourg the challenge is to establish that they have a substantial presence there.

The Luxembourg regulator, the Commission de Surveillance du Secteur Financier (CSSF), is currently very focussed on ensuring that any proposed new AIFM applying for authorisation is able to demonstrate that it has significant and robust infrastructure in place in Luxembourg. The CSSF will be particularly focussed on an AIFM's risk management capabilities and also the extent to which any portfolio management capabilities may be delegated. The CSSF may be quite intrusive in both the authorisation process and subsequently in its supervisory approach as it seeks to ensure that new AIFMs are not mere letterboxes. At the very least, the CSSF will expect to see a real physical presence comprising at least two full time employees. This approach by the CSSF is driven in part by a desire to ensure that it does not overlook key emerging risks in the sector, and also it is driven by a desire to head off any criticisms by ESMA of its approach. That said, the CSSF remains supportive of firms seeking to establish AIFMs in Luxembourg.

Tax and VAT issues

Any AIFM considering establishing a subsidiary or related management entity in another EU jurisdiction will need to consider potential tax issues, both in the UK and in the other jurisdiction. If all or part of an existing business is being moved from the UK to a subsidiary in another jurisdiction, then this may trigger tax charges in the UK, although it is possible that various reliefs may apply to exempt or at least postpone the crystallisation of a charge. It may also be possible to structure matters such that no disposal event arises in the first instance.

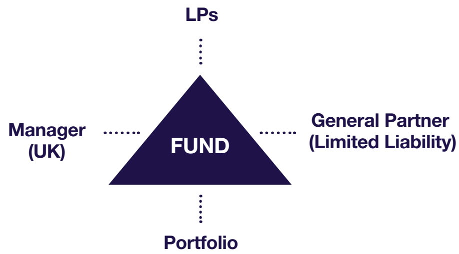
The new entity will also be subject to tax in the other jurisdiction on profits made from its activities, and transfer pricing rules in both the UK and the other jurisdiction are likely to apply to require that all transactions between the two entities are carried out on arm's length terms.

Where the new EU management entity delegates, say investment management, back to the UK, then VAT issues will be need to be considered. Typically the UK will not levy VAT on the services provided by a UK business to a business in another EU country, and the issue will then be whether the EU entity is required to 'reverse charge' itself VAT on that service. If a reverse charge does apply the issue then is whether the VAT so charged will be recoverable, which in turn will often depend upon whether the EU entity is required to charge VAT on its management services to the fund in question. In Luxembourg for instance, the management of most investment funds is exempt from VAT, and management services outsourced to third-party managers will generally also benefit from the VAT exemption under certain conditions, meaning no reverse charge. However, each situation needs to be carefully analysed, as it is possible that irrecoverable VAT may arise in certain scenarios which could increase overall costs of operating the fund.

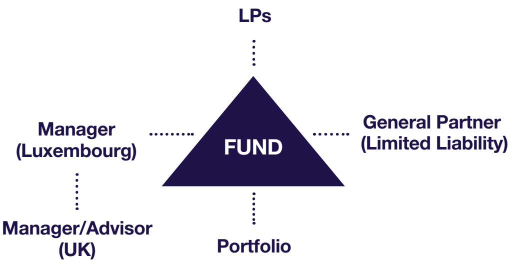
Structure

The following structure charts set out in high-level terms the current and future structures of affected AIFMs:

Pre-Brexit structure



Post-Brexit structure



Other issues and transactional documentation

Apart from regulatory and tax issues, there will be multiple other issues to be considered when concluding whether to establish a subsidiary in Luxembourg or other EU jurisdiction, including, in particular, the extent to which there is a UK TUPE transfer of employees from the UK entity to the new entity, and also the outsourcing/contractual agreements that will need to be entered into between the subsidiary and the UK entity as 'sub-manager' or 'sub-adviser'.

Any such transaction is likely to trigger the requirement for the following principal documentation to be negotiated and agreed between the relevant parties:

- a new management agreement between the Luxembourg (or other EU-based) AIFM and the fund;
- a sub-management or sub-advisory agreement between the AIFM and the UK manager or adviser;
- the corporate and constitutional documentation to establish the new subsidiary;
- a business transfer agreement under which certain assets, services and employees will be transferred to the new EU-based AIFM; and
- potentially, other services or transitional agreements to ensure the EU-based AIFM can operate effectively from day one.

Other regulatory considerations

Any AIFM considering a restructuring to make it 'Brexit proof' will also need to consider two other regulatory issues that are likely to impact upon the structure of AIFMs in the short-term. The first of these is the extension of Senior Managers and Certificate Regime (SM&CR) to all UK FCA authorised firms in 2018. The second is the FCA's final remedies relating to its Asset Management Market Study. These issues are summarised in Appendices A and B respectively.

Timing Considerations

We know from existing live mandates that the timetable for such Brexit-driven restructurings can take up to 18 months. If you are considering such a restructuring, the time for implementation has arrived.

> 'Some UK AIFMs are now looking at establishing a legally distinct subsidiary in, for instance, Luxembourg. In general terms subsidiaries have to obtain individual authorisation to be permitted to undertake relevant regulatory activities, whilst branches of a firm established in another member state can rely upon passported permissions from the parent entity.'

Adverse fund economics

In some funds it becomes apparent during its life that the portfolio is under-performing, meeting neither the economic expectations of LPs nor the manager. This scenario can trigger a material restructuring of the fund which will likely require a significant re-negotiation of the principal fund documentation, and increasingly this restructuring is being initiated and driven by the GP itself (commonly referred to as a GP-led restructuring).

Re-setting the economics of the fund

In some cases there is a need for the manager to be re-incentivised because the fund reaches a point where it may never exceed the hurdle required to start paying carry to the manager, in which case, by consensus between the LPs and the GP, the waterfall provisions in the fund limited partnership agreement may be amended and restated.

To accomplish that amendment and restatement, consideration will need to be given to the amendment provisions in the agreement, which will usually permit amendments of such a material nature provided all LPs consent in writing (given that all their positions relative to the GP and manager will be made worse if, for instance, the hurdle to achieve carry is proposed to be reduced).

As well as the amendment provisions, there may also be provisions in side letters with certain LPs that may need to be respected in order to amend the waterfall provisions. And in any such scenario, a detailed tax analysis will need to be undertaken to understand whether such a proposal could impact on any of the relevant parties' tax positions.

Separate to the carry, the parties may also conclude that the management fee payable to the manager needs to be varied, in which case there will need to be an amendment to the fund limited partnership agreement which typically will set out the 'General Partner's share' that is payable as a first priority from the fund to the General Partner (which will trigger the same amendment and restatement requirements as described above), and also a written amendment to the management agreement between the General Partner (GP) and the manager.

Exiting LPs

In some scenarios, certain LPs may decide they wish to exit the fund because their returns are lower than expected. In such cases, one or a number of LPs may seek to exit via a secondary transaction, either to existing or new LPs. This may or may not happen in conjunction with a resetting of the fund economics. If the fund is seriously underperforming, this is likely to result in the pricing of the secondary trade being at a significant discount to net asset value.

In any secondary trade, close regard will need to be paid to the transfer provisions in the fund limited partnership agreement, including in particular whether the GP's absolute consent is required, or whether the consent threshold is 'not to be unreasonably withheld or delayed' by the GP. There may also be other restrictions on transfer, including stringent 'know your client' requirements that will need to be satisfied by the incoming LP(s), restrictions on transfers to competitors, and in some cases pre-emption rights in favour of other LPs, either in the fund limited partnership agreement or relevant side letters.

Typically, a secondary trade will need to be negotiated and agreed with the selling LP(s), the purchasing LP(s) and the General Partner setting out the terms of the transaction. Such agreements contain quite bespoke warranties and indemnities from the selling LP(s), and the consideration for the purchase will based on a certain net asset value per unit in the fund (usually by reference to the end of the last reporting period of the fund), and then adjusted for subsequent drawdowns from and distributions to LPs.

Unless the fund is a Private Fund Limited Partnership (PFLP), new LPs coming to the fund (assuming the fund is an English limited partnership) will trigger a requirement for a notice to be lodged in the London Gazette, in order to comply with the Limited Partnerships Act.

Changes to the GP and manager

In some extreme cases, an under-performing fund may result in the LPs requiring a change to the GP and therefore, by extension, the manager. Typically, the fund limited partnership agreement will contain 'fault' and 'no fault' divorce provisions entitling the LPs to remove the GP and replace it with another GP.

In such circumstances, it will usually be the case that the LPs will need to rely on the 'no fault' divorce provision on the basis that underperformance will not amount to fraud, gross negligence or the other thresholds required to be met in the fund documentation to trigger the 'fault' divorce provision. Fund documentation does vary, but typically LPs representing 90% of commitments will need to approve the triggering of the 'no fault divorce' provision, which is obviously a high threshold and therefore may be difficult to achieve in practice.

If the GP is to be removed, there will also need to be a consequent termination of the existing management agreement between the GP and the manager, and a replacement agreement entered into with the new manager, or alternatively a novation of the existing agreement to the new manager.

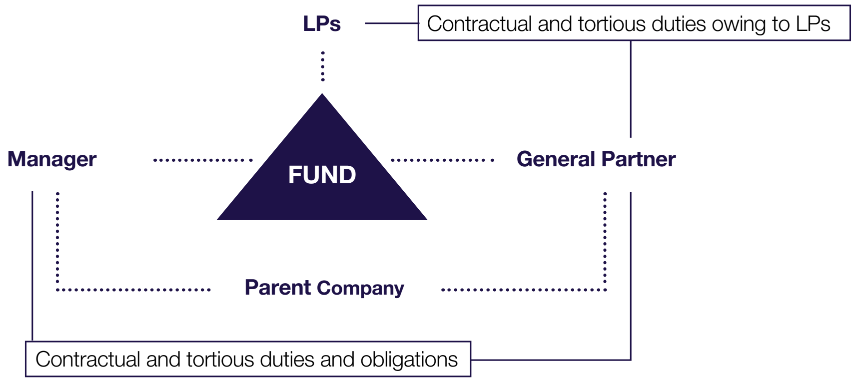
To effect this change, there should be (but isn't always) an automatic right for the GP to terminate the management agreement in circumstances where the 'fault' divorce provision in the fund limited partnership agreement is exercised. If those provisions do not interact properly with each other, careful consideration will need to be given as to how to terminate or novate the existing management agreement.

In replacing the GP and manager, thought will also need to be given as to how to treat any GP commitment which has already been drawn, and also the extent to which the manager is entitled to receive any further management fees or carry up to the point of termination. The fund documentation will usually include provisions which pre-determine these economic entitlements in such a termination scenario.

Finally, if the management agreement is well drafted, there will be a set of handover or wind-down provisions which provide for an effective and pragmatic process to be implemented in circumstances where management of the fund is being handed to a new manager.

Mechanisms for enabling the settlement of disputes between the LPs and the GP

Investors will often invest via a limited partnership fund structure as follows:



In this structure, as LPs, investors will take no part in the management of the fund, and will not be liable for its debts and obligations other than receipt of that LP's capital. The General Partner is responsible for the fund's management and its debts and obligations. The GP has contracted, on behalf of the fund, with a fund manager entity (the manager) to manage the fund and invest the monies put in by investors. The GP and the manager are subsidiaries of the same parent company.

Particular features of this structure can act as hurdles in the event investors wish to seek recourse when an investment by the fund is (allegedly) negligently made or mismanaged. These include:

- The LPs have a direct relationship with the GP, but the GP is not responsible for investment decisions and management of investments as it has sub-contracted these responsibilities to the manager;
- The LPs do not have a direct relationship with the manager which has made the investment decisions and managed the investment;
- The GP does have a direct contractual relationship with the manager. Having entered into this contractual relationship with the manager, on behalf of the fund, the GP can claim against the manager in the name of the fund. The commencement, conduct and settlement of proceedings is within the GP's role and responsibilities. However, the GP shares the same ownership as the manager. In these circumstances the GP will be conflicted from taking action against the manager on behalf of LPs to whom it owes duties.
- As Limited Partners, the LPs cannot commence proceedings in the name of the fund, as to do so would be to take part in the management of the fund, opening them up to liability for its debts and obligations.

Henderson: An attempt to overcome these hurdles

In the Henderson case[1], certain LPs in Henderson PFI Secondary Fund II sought an order from the court allowing them to sue the GP and the manager by way of a derivative action in the name of the fund but without potential liability either for the debts and obligations of the fund or for the costs of the derivative action.

1 *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LLP (a firm) and others [2012] EWHC 3259 (Comm)*

> ‘It remains to be seen if the Courts will take a different approach to private fund limited partnerships (PFLP), which can now be established following the Legislative Reform (Private Fund Limited Partnerships) Order, which came into force from 6 April 2017.’

The classic example of a derivative claim is a claim by a minority shareholder who seeks to bring a claim on behalf of the company against wrongdoers who are in control of the company. In *Henderson*, the LPs argued that there was no reason in principle why Limited Partners could not bring such a derivative claim on behalf of the limited partnership.

However, in its decision, the High Court found there was no need for a derivative action by the LPs against the GP in the name of the fund as they could each individually sue the GP anyway. As to a derivative claim by the LPs in the name of the fund against the manager, the High Court decided that such a claim could be brought by the LPs, but only if they accepted liability for the debts and obligations of the fund (as if they were the GP managing the fund). This clearly is not satisfactory for LPs unwilling to lose limited partner status.

It remains to be seen if the Courts will take a different approach to private fund limited partnerships (PFLP), which can now be established following the Legislative Reform (Private Fund Limited Partnerships) Order, which came into force from 6 April 2017. The order sets out a ‘white list’ of activities that LPs in a PFLP will be able to carry out without being considered to be taking part in the management of the PFLP, including “enforcing an entitlement under the partnership agreement, provided that the entitlement does not involve a Limited Partner taking part in the management of the partnership business”.

However, given the clear view expressed in Henderson that the conduct of litigation on behalf of the fund would involve LPs in the management of the fund, and that a claim against a manager by the PFLP will not likely entail the enforcement of an entitlement under the partnership agreement, LPs in PFLPs may be prejudiced if they commence a derivative claim against the manager in the same way LPs in a limited partnership would be.

Other possible solutions to allow a dispute to be brought and settled

In the Henderson case, several other suggestions were mooted:

- That the LPs replace the conflicted GP by a new, unconflicted, GP free to sue the manager in the name of the fund. The problem with this approach, as noted in *Henderson*, was that it might not be practical or cost-effective to appoint a new GP willing to assume the debts and obligations of the fund and the risks this entails. It also might not be in the best interests of the fund (and the LPs) to replace the GP in this way, having in mind the smooth management of all of the fund’s investments.
- That the LPs sue the GP for its failure to take action against the manager. However, as noted in *Henderson*, the test for liability would be different from that which would apply to the determination of the liability of the manager. Further, the test for damages and their measure would also differ. Also, the GP may be a shell with no assets. Such proceedings might therefore be unattractive by comparison to a direct claim against the manager.

An alternative approach which has sometimes been proposed is for an administrative receiver to be appointed by the conflicted GP (at the behest of complaining LPs) for the discrete purpose of investigating and, if necessary, pursuing a claim by the GP on behalf of the fund against the manager. However, as with the possibility of replacing the conflicted GP with another unconflicted GP, this approach is likely to entail considerable expense and cause disruption to the management of the fund and all of its investments. The parent company of the GP (and the manager) may also resist the appointment of an administrative receiver as it will not want such a receiver to be given control over (part of) the operations of its subsidiary.

Appointment of a committee

Another approach, and one not explored in Henderson, is the appointment of an independent committee to oversee the settlement of the dispute, which has its basis in a real-life example. In the case in question, a group of LPs wanted a potential claim for negligence against a fund's manager to be investigated and pursued by the fund's GP. The GP was conflicted but was able, acting in accordance with a provision in its company articles of association, to appoint an independent committee comprising non-conflicted reputable fund professionals to investigate, and ultimately pursue, a claim against the manager in the name of the fund. This approach satisfied the complaining LPs as well as the GP and its parent. The board of the GP delegated power to the independent committee to fulfil this role and agreed to be bound by decisions it made within the scope of its competence but otherwise retained its other existing functions, enabling the smooth management of the fund to continue and the claim to be brought with the minimum disruption and expense.

This solution applied a provision in the GP's articles of association but even if a GP did not have articles of association permitting the delegation by the board of some of its powers to an independent committee, then a variation of this theme would be to appoint a number of non-executive directors and then form them into a sub-committee of the board charged with investigating and pursuing a claim against the manager. Alternatively a GP could amend its articles to insert a provision permitting the appointment of an independent committee to which the board could delegate powers.

The conflicted limited partnership fund structure described above is not uncommon and can present difficulties to LPs wishing to bring claims for recourse when an investment goes wrong. It also complicates matters for conflicted GP entities. Such GPs must reconcile their relationship with sister company managers with the duties they owe to LPs. Failure to do so places the GP at risk of being targeted by a claim for breach of the duties it owes to LPs, for example by failing to bring a claim against the manager. Fund managers should therefore carefully consider the pros and cons of this structure, including these issues, when establishing funds, and also think carefully when documenting new funds as to whether to include specific mechanisms to permit claims to be brought by LPs in a manner which navigates through these conflicts.

Investor default

The most common form of investor default in closed-ended private equity funds is an LP's failure to comply with a drawdown notice. The consequences can be severe for the defaulting LP and can also cause fund sponsors significant problems in making portfolio investments and operating the fund.

In typical fund documentation, LPs commonly have 10 business days to meet a drawdown notice once served on them by the fund manager, and for institutional investors this is usually sufficient notice to arrange funding (although in some instances certain types of investor may require longer drawdown periods which sometimes can be incorporated into the terms of a side letter). Should an LP not comply with a drawdown notice, interest will usually be charged at a high rate until such funding default is remedied.

An LP's failure to remedy a breach of its funding obligations will give rise to various options for the fund manager under the terms of the fund documentation. Fund managers will often be permitted to call the defaulted amount from the other non-defaulting LPs, usually pro rata to their respective commitments to the fund. However, this right is sometimes subject to a cap, and if the defaulted amount exceeds such a cap, or this option is not permitted under the fund documentation, alternative approaches to meeting the shortfall will need to be considered.

Raising the requisite additional capital may be achieved through a variety of methods, including: (i) seeking a waiver of a cap on drawdowns from non-defaulting LPs; (ii) seeking a co-investment partner to participate in the proposed investment; or (iii) sale of a defaulting Limited Partner's interest to the non-defaulting LPs and/or a third party.

A defaulting LP may be obliged to forfeit its interest (at a discount price of 25% to 50% or greater) in the fund. Forfeiture of an LP's interest will result in expulsion from any LP advisory

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committee and the Limited Partner should then be prevented from participating in investor meetings and votes.

The introduction of a co-investor may require the establishment of a separate co-investment vehicle, and negotiation and settlement with that co-investor of a co-investment agreement. One particular area of negotiation will be the quantum of management fee and carry that the co-investor will need to pay to the manager of the fund.

Disposal of defaulting LP's interest

The ability of the GP to sell the defaulting LP's entire interest in the fund to the non-defaulting LPs and/or a third party at a discounted price is a common consequence of an LP default. Often the non-defaulting LPs will have a pro rata right of pre-emption over a sale to a third party, with scale back mechanisms to deal with the scenario where demand exceeds supply.

Depending on a range of factors including the nature of the fund, the profile of the sponsor and prevailing market conditions, restructuring the fund by forcing a sale of the defaulting LP's interest to a third party may be onerous on the sponsor.

One potential scenario is that a placement agent is appointed to assist with the disposal. Placement agents often charge a success fee as well as a fee linked to any subsequent fund commitment from any third party investors identified and introduced by such placement agent, and will often seek their own right to participate in the fund on preferential terms.

If the defaulting LP is a cornerstone investor, the future success of the fund is likely to be severely compromised. If the default occurs early on in the fund's lifecycle and non-defaulting Limited Partners are not required or are unwilling to meet any investment shortfall, and/or replacement investors cannot be found, the manager may have little option but to terminate the fund prematurely resulting in significant financial losses for all involved.

Depending on the commercial arrangements, a cornerstone investor may have rights to carried interest in the fund. A default by such a cornerstone investor resulting in the sale of its interest to a third party may have consequences not only at fund level but will also likely result in changes to the fund's carried interest arrangements.

LP default may also impact the fund's financing arrangements, in that it may trigger the acceleration of existing loans or termination of the fund's facility agreements. Depending on the terms of the facility agreement, it is not uncommon to see a requirement for lender consent on the sale of any LP interest.

As summarised above, the outcomes arising from an LP default can be varied and are often serious for sponsors, defaulting LPs and also non-defaulting LPs, and will often result in some form of restructuring of the fund.

For fund sponsors, establishing a good working relationship with potential investors and LPs, and performing appropriate due diligence before accepting commitments from investors, is key to ensuring the risk of Limited Partner default is minimised during the term of the fund. And funds will often enter into facility agreements secured on undrawn commitments from LPs to 'smooth' the drawdown process.

In any event, it will also be incumbent on the fund manager to ensure a reputable fund administrator is appointed so that the drawdown process is managed effectively with a view to mitigating the risk of investor default.

Intra-manager disputes

The fund manager (or 'Manco') will typically have discretion to manage the affairs of the fund on behalf of investors. Where a dispute arises between the key persons within the Manco, decision-making processes may be significantly impaired which could have a serious impact on the operation of the fund.

The types of dispute which may arise at the Manco level depend on the ownership structure of the Manco and also the extent to which power and influence is concentrated. In some cases, decision-making will rest with one senior partner, making internal disputes unlikely. In other cases, the Manco may be controlled by a diverse group of partners, each with their own interests.

Disagreements might relate to economic issues (e.g. how to 'split the cake') or control issues (e.g. who has the final say over certain investment decisions). In many cases these disputes will be resolved internally, often without the knowledge of investors in the fund, but in some cases they can lead to pre-litigation or litigation which can have a material adverse impact on the operation of the fund.

Constitutional documents

If a dispute arises, the constitutional documents of the Manco will need to be closely analysed. Depending on how the Manco is structured, these will comprise a shareholder agreement and articles of association in the case of a corporate entity, or an LLP deed in the case of an LLP. If the Manco is incorporated in an EU jurisdiction, which may become more likely over time to ensure access to EU investors post-Brexit, other types of constitutional documents will become relevant.

To mitigate the risk of a dispute over economic issues, a Manco's constitutional documents should clearly stipulate each individual manager's percentage share of the Manco's profits and capital, his or her entitlement to drawings in anticipation of profit share, and also any applicable good/bad leaver provisions.

However, economic interests in the Manco (including, in particular, in relation to carry entitlements) will change over time as the management team grows and evolves, and there are joiners and leavers. These changes are not always reflected in updated versions of the constitutional documents, leading to uncertainty at a later stage as to individuals' respective entitlements.

To mitigate the risk of disputes over control of the Manco, the constitutional documents should set out the agreed procedure for decision-making, including the formation of bodies such as an 'investment committee' to determine certain investment decisions, and which are governed by clear rules as to notice, quorum and adjournment (so as to ensure one partner can't delay or prevent effective decision making at a Manco level). Again, the decision-making procedures set out in the constitutional documents may become blurred by changes in circumstance during the life of the fund, and also changes over time in the management team.

Dispute resolution mechanisms

Provided the potential for disputes between partners in the Manco are considered at the formation stage, the constitutional documents can be tailored to include mechanisms for resolving disputes, or at least allowing one or

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'The introduction of a co-investor may require the establishment of a separate co-investment vehicle, and negotiation and settlement with that co-investor of a co-investment agreement. One particular area of negotiation will be the quantum of management fee and carry that the co-investor will need to pay to the manager of the fund.'

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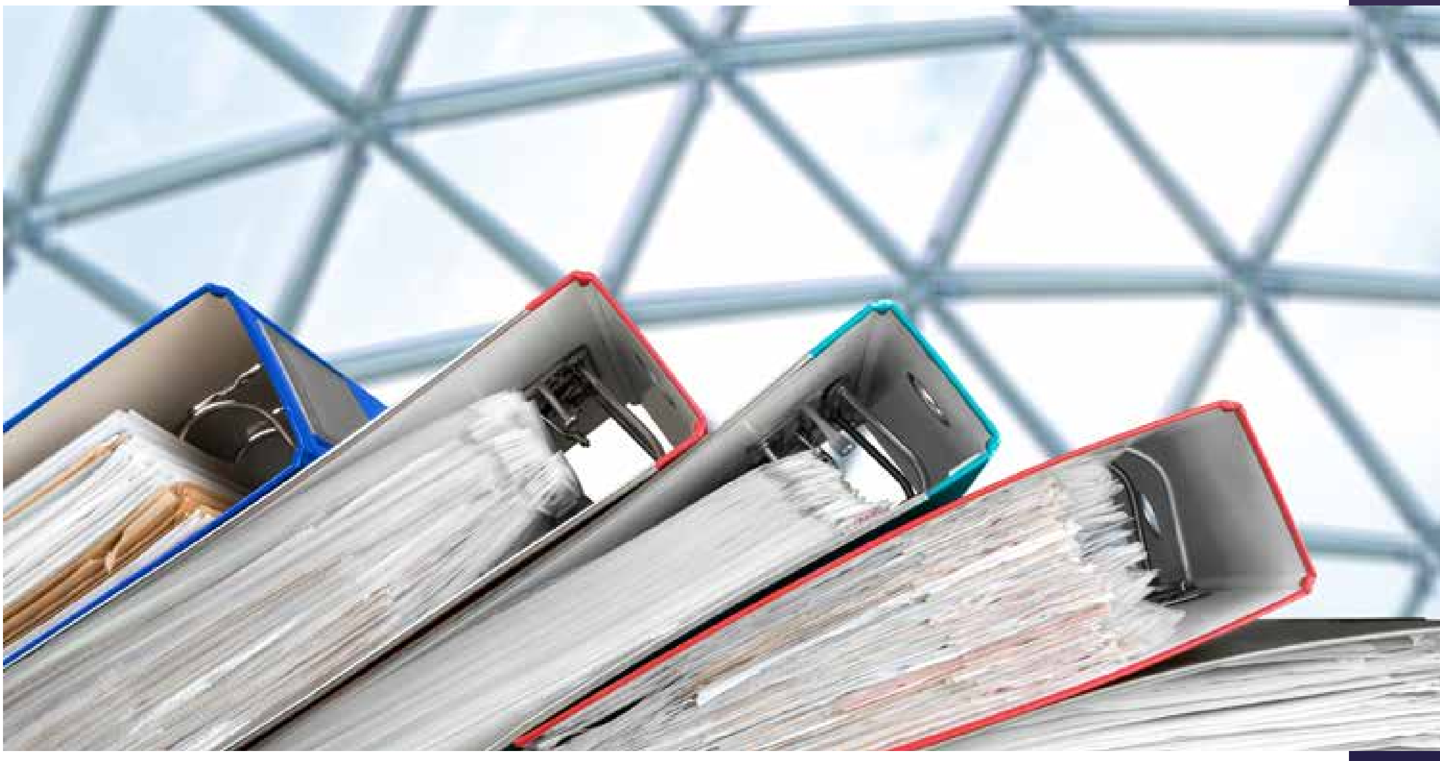
more individual partners to exit without a wider impact on the Manco, the GP or the funds the Manco manages.

One approach is to have different classes of member, with those classes having different levels of decision-making power. So, for instance, a shareholder agreement or LLP deed could have 'A members' and 'B members', with the 'A members' effectively having control over most decisions, but with more fundamental decisions (for instance merger or insolvency) requiring a super-majority or unanimous approval of all members, but with these rules being subject to investment decisions being delegated to the investment committee.

Most constitutional documents will be specifically structured to mitigate against the risk of deadlock, for example by having odd numbers of votes or by one party having a casting vote. However, it is sometimes impossible to avoid deadlock scenarios where two or more parties have equal interests in the Manco, or where it is not possible for the parties to reach a unanimous decision on a reserved matter. The constitutional documents should then set out a deadlock procedure, which may start with the escalation of the deadlock matter to the highest decision making authority, and if that does not resolve the dispute in question, an exit procedure may then apply in which a member can sell out or require another member to sell out. These exit mechanisms will differ from one Manco to another, and are usually negotiated in detail.

In some cases, the use of exit mechanics in the constitutional documents might not involve a mutual agreement between the parties as to the transfer of interests in the Manco, but rather a compulsory transfer or expulsion. In this scenario, the majority owner(s) of the Manco, or the party with control over decision-making, may force a non-consenting party to surrender or transfer their interest. This may be for no or nominal consideration (particularly where the non-consenting party is seen to be 'at fault' or is a bad leaver), or for what is considered (based on a pre-agreed formula) to be a fair market value (which may then be determined by an independent valuation expert where the parties can't reach agreement on price).

While considering exit mechanisms and expulsion of members may seem a heavy-handed way to deal with even minor disputes, including these provisions in the documents allows for a fall-back option where such disputes cannot be resolved in



an amicable manner. Given the operations of the Manco may be put on hold while any dispute is on-going, with the Manco unable to manage the affairs of the fund in the meantime, it is important to consider the mechanisms for dispute resolution at the formation stage of the fund. Where such mechanisms are included in the constitutional documents, the wording of those documents will be critical in ensuring a quick and clean resolution. If the wording is not clear, or if the constitutional documents do not allow for these sort of resolution mechanisms, the next step may be litigation.

Litigation

There is always risk in litigation, even if a case is considered at the outset to be strong from a legal perspective. However, sometimes preparing for litigation, including the mandatory pre-action exchange of correspondence and ultimately issuing a claim, may be the only way to break an impasse and resolve a dispute which has arisen. Even if a claim is not taken to trial, the process of litigation very often prompts a commercial resolution.

Litigation is a dynamic process where new legal and factual issues or documents come into play which materially impact the likelihood of success. However, not every dispute requires the full panoply of litigation procedures and there are a number of processes which allow a more tailored approach.

Careful thought should therefore be given at the fund formation stage as to the ownership and control of documentation. Documents may be created at various stages, even before there is any hint of a dispute, without thought as to who (the Fund, the GP, or the manager) owns or controls them, who the client of the advising lawyer is and whether legal privilege may inadvertently be waived by the broad dissemination of legal advice. At a practical level, when dealing with legal advice, care should be given as to whom it is disseminated. A common cause of potential problems arises out of individuals being copied on emails relating to legal advice without regard to the legal entity that they represent.

If a dispute is in contemplation, then litigation privilege will arise giving parties greater protection for their legal advice and it is important that parties have a very clear view on who is being advised so as to avoid a waiver of privilege. If litigation is commenced, relevant documentation may need to be disclosed during the course of proceedings, even if it is commercially sensitive or embarrassing. The most straightforward way to avoid these issues is to address questions of ownership and control before contentious issues arise.

Regulatory considerations

If the chosen method of resolving an intra-Manco dispute involves a change in the ownership or management of the Manco, the parties will need to consider the relevant regulatory filings. For example, if there is a change in control of the Manco, it will be necessary to receive the FCA's prior consent on the assumption the Manco is an AIFM.

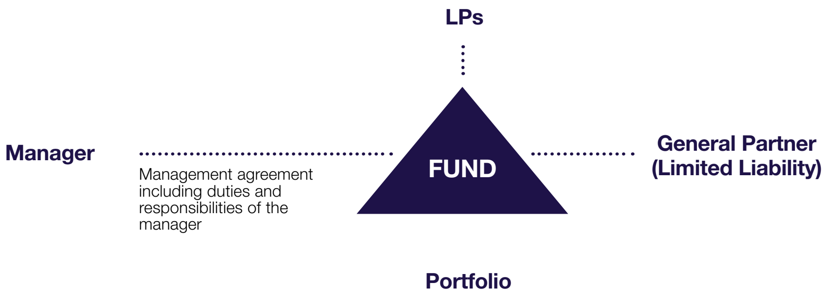
Other contractual issues

In addition to triggering regulatory filings, a change in control at the Manco level may also cause issues in relation to other contractual arrangements. In particular, where the fund has external debt at fund level, the finance documents may include a change of control clause which could trigger repayment of the facility. And crucially, a departure of senior personnel from Manco could trigger the key-man provision in the fund documentation requiring a suspension or even cancellation of the fund's investment period.

'Litigation is a dynamic process where new legal and factual issues or documents come into play which materially impact the likelihood of success. However, not every dispute requires the full panoply of litigation procedures and there are a number of processes which allow a more tailored approach.'

Insolvency of the fund manager

Typically, the relationship between a fund manager and the fund it manages will be as follows:



The fund manager will use its skills and experience to maximise the value of the fund. It will be responsible for the return to LPs of income generated from their investment and ultimately the return of LPs' capital.

The duties and responsibilities of the fund manager will normally be set out in detail in the management agreement between the GP of the fund and the manager. Typically, either the manager or another entity in its group will be a sub-threshold or fully authorised AIFM, and therefore regulated by the FCA.

Although insolvencies of fund managers are relatively rare, in part because their overheads are likely to be more than covered by the income generated from management fees and carry, scenarios have arisen where managers of funds enter the realm of financial distress either because of financial mismanagement or a significant third-party claim being made against the manager.

The directors of any UK company or LLP entering a period of financial distress will always have to be mindful of the risk of personal liability if that company or LLP commits wrongful trading, which broadly is where an insolvent company has continued to trade in a way which worsens the position of the creditors that any reasonable director would not have allowed. If wrongful trading is proven, then the directors can be made personally liable for the company's debts from the time they knew the company was insolvent.

In circumstances where a fund manager becomes insolvent, regard will need to be taken to the contractual arrangements entered into in relation to the fund manager, and also CASS and the FCA's regulatory framework for insolvencies of investment management firms, which will be explored in more detail below.

The contractual framework

A typical management agreement between the GP of the fund and the manager will include a reciprocal right of either party to terminate the agreement immediately, or on a very limited period of notice, in circumstances where either party undergoes an insolvency type event. A typical clause would read as follows:

> *"Either party shall be entitled to terminate the ma nagement agreement by giving notice to the other party in writing if the other party goes into liquidation (except voluntary liquidation for the purposes of reconstruction or amalgamation upon terms previously approved in writing by the terminating party) or is unable to pay its debts as they fall due or if an administrator over any of its assets is appointed or if some event having an equivalent effect occurs."*

Whether or not that right is exercised by the GP will need to be carefully determined. In addition, consideration will need to be given as to how that right could be exercised, given that the GP is often a shell entity effectively controlled by the fund management group. In negotiating fund documentation, LPs should consider how in practice a GP would ever be entitled to exercise this right under the management agreement.

One mechanism might be to ensure that directors of the GP who are also directors or principals of the fund management group recuse themselves from the relevant board meetings resolving to terminate the management agreement, but this pre-supposes that the board of the GP comprises one or a number of independent directors who would then be able to exercise that right.

As well as the termination provisions in the fund management agreement, consideration will also need to be given to the provisions in the fund limited partnership agreement (or equivalent document), which typically entitle the LPs to remove the GP with or without cause provided a certain LP voting threshold is obtained.

There is often a complex interplay between these provisions and the termination provisions in the management agreement, but two key questions that will often need further analysis are whether insolvency of the manager triggers the right of the LPs to remove the GP for cause; and also whether it is the removal of the GP, either for cause or without cause, that triggers an automatic termination of the management agreement.

If the manager is or is nearing financial distress there may also be ramifications under the banking facilities at the 'fund' level, for instance under pledge or commitment facilities, which may give the lender acceleration and enforcement rights in such a scenario. Although less likely, it is certainly possible in theory that banking facilities at the portfolio company level could trigger acceleration or enforcement rights if the manager undergoes an insolvency event.

The regulatory landscape

One of the FCA's primary functions is to protect investors, in particular in relation to the safeguarding of client monies and the distribution of those monies to clients as soon as possible where an insolvency scenario has arisen. The relevant FCA rules relating to firms' treatment of client assets is known as CASS.

If a fund manager holds client assets and becomes insolvent, a 'Special Administrator' may be appointed under the Investment Bank Special Administration Regulations 2011/245, which

'A Special Administrator is appointed by court order and, as in the case in all administration proceedings, he/she must be a licenced insolvency practitioner. The FCA will also have to be assured of his/her competence in the field of financial services, otherwise it can object to the appointment of that Special Administrator.'

introduced the Special Administration regime following the Lehman Brothers insolvency. The Special Administration regime works with CASS, and in particular the new client money distribution rules (CASS 7A), to provide a mechanism under which client assets can be returned to clients in the event of an investment fund failure. The new CASS 7A rules, for instance, allow the Special Administrator to transfer client assets without those clients' consent, and also provide for contracts for services for safe custody of client assets to continue notwithstanding the Special Administration.

A Special Administrator is appointed by court order and, as in the case in all administration proceedings, he/she must be a licenced insolvency practitioner. The FCA will also have to be assured of his/her competence in the field of financial services, otherwise it can object to the appointment of that Special Administrator.

If the fund manager holding client assets is authorised by the FCA (including small authorised AIFMs who are below the thresholds in Regulation 9 of the Alternative Investment Fund Managers Regulations 2013) it must give the FCA two weeks' notice of any preliminary steps the fund manager takes to go into liquidation or administration. The FCA will then decide whether to allow the fund manager to enter a normal insolvency process, to take over the proceedings or to apply to court for a Special Administration Order. A licenced insolvency practitioner would be brought in by the board and requested to give a view on whether it would accept such an appointment, i.e. whether the financial circumstances of the fund manager were such that Special Administration would be the appropriate course.

Other forms of insolvency regime, e.g. creditors' voluntary liquidation and ordinary administration, are not available in circumstances where the Special Administration regime applies. If the FCA does not insist on the application of the Special Administration regime then a normal insolvency process will apply.

The appointment of a Special Administrator will not impact on the management agreement. If, notwithstanding the appointment of a Special Administrator, the GP elects not to terminate the management agreement, that agreement will continue in force but the GP will then deal with the Special Administrator and his or her staff. In practice, there may be good reason not to terminate the management agreement pending an orderly resolution of the insolvency.

Regard should also be had to the FCA's *Wind-Down Planning Guide Instrument 2016*, which envisages firms preparing 'wind-down plans'. A regulated firm's wind-down plan must be presented to the FCA and is intended to cover various scenarios, including an unexpected crisis or insolvency which makes the firm unviable. A fund manager wishing to maintain good relations with its regulator should consider producing such a plan as part of its general compliance obligations even where it has been operational and regulated for a significant period. Any such wind-down plan would make the Special Administrator's job much easier as there will be signposts and pathways enabling him to identify the different pools of client assets being held, the terms on which they are held and what percentage of each pool's assets are available as against claims on those pools.

Although insolvencies of fund managers are rare events, where applicable the Special Administration regime could help to ensure that client assets are safeguarded and distributed in relatively short order.

Key liabilities and defences for asset managers

Case law and experience would suggest that there are three key areas of liability for asset managers: breach of investment mandate, 'conviction plays' and operational errors.

Breach of investment mandate

Negligence claims against fund managers (e.g. for negligent selection of assets or investment strategies in a discretionary portfolio) in the absence of mandate breaches are rare. This is because investors will generally fail to achieve what is known as the 'Bolam standard', proving that on the balance of expert opinion no reasonably competent fund manager could have used that strategy or made that selection of assets. The most recent example of that type of claim was the Unilever v Mercury case.

Investors looking to sue for investment performance losses will therefore base their claims primarily on breaches of the investment mandate (contained either in the investment management agreement or relevant fund limited partnership agreement).

There is also a sub-set of breach of mandate claims which focus on the investment manager's alleged failure to undertake adequate due diligence or risk analysis on an investment.

Conviction plays

'Conviction plays' are a category of loss which occurs where a senior and powerful investment manager, usually a major market figure whose judgment is not questioned, makes a radical one-off investment which can create significant breaches of mandate, in terms of both the composition of the portfolio and the intrinsic features of the investment. Conviction plays may be characterised by a lack of team oversight or any involvement from the investment committee.

Operational errors

Although less relevant to pure private equity funds, operational mistakes in managing or trading assets include 'fat finger trades', where a fund manager buys the wrong asset; or buys the right asset but exceeds his mandate; or simply fails to execute a trade.

These types of claims (providing there is a clear picture of the facts, liability and quantum) are generally settled relatively quickly by professional indemnity insurers.

Defences

There are typically several defences available to fund managers that need to be assessed to determine liability and, if there is liability, the measure of recoverable loss. In the context of a breach of mandate claims, fund managers should consider the following:

- Whether the claimant investor has waived its right to sue, or is held to be estopped (estoppel by convention is the most likely category) from suing the fund manager (for example, by communicating through his words or conduct that he will not enforce the terms of the mandate against its fund manager);

- Whether the mandate contains: (i) an indemnity for investor claims (where the indemnity is provided by the fund itself), (ii) an exculpatory/hold harmless clause, or (iii) a 'General Discretion' clause. These will typically be qualified so that they will not be triggered by gross negligence or wilful default.
- What sum is actually recoverable as damages, in particular considering: (i) whether a market-driven element of the loss claimed as damages is within the scope of the duty of care owed to investors – i.e. whether it is a category of loss for which the fund manager has assumed responsibility to the investor – and, (ii) whether the loss claimed is too remote – i.e. whether the type of loss is within the contemplation of the parties at the time of the investment and is thus a foreseeable consequence of the breach.
- What the relevant date for assessment of the damages should be, which is an evolving area of law. Based on the principles most recently applied in *Gestmin* v *Credit Suisse*, this will be the earlier of (i) the claimant investor knowing about the breach of mandate and, (ii) the claimant investor being able to offload the non-compliant investment into the market (if practicable).
- The possibility of offsetting profits generated for the claimant investor by the same investment strategies that created the losses claimed as damages – see *Needler Financial Services* v *Taber*.

Practical measures for fund managers to consider

Mandate comprehension and due diligence: ensure fund management teams have a current working knowledge of mandates and their terminology; ensure there is a due diligence procedure in place for all non-mainstream assets; and consider potential for software that can cross-check asset classes invested against the terms of the mandate and identify any product or asset class compliance issues that may need to be addressed.

Focussed contractual analysis: review the investment management agreement to check the wording of any indemnity, exculpatory or 'General Discretion' clauses.

Client approval for asset classes: review the process by which investor clients approve assets in their portfolios, ensuring maximum transparency and engagement from the client investor in approving (to the extent possible) leveraged and other special asset classes which may be at the perimeter of the investment mandate.

Notification to investors: consider whether there is a need to notify investors under the fund documentation to the extent a claim has arisen against the manager.

Glossary

Abbreviation	Definition
AIF	An alternative investment fund
AIFMD	The Alternative Investment Fund Manager's Directive
AIFM	An alternative investment fund manager
AMMS	The FCA's Asset Management Market Study
CASS	The FCA's rules relating to firms' treatment of client assets
CSSF	The Commission de Surveillance du Secteur Financier, being the Luxembourg financial regulator
EEA	European Economic Area
ESMA	The European Securities and Markets Authority
FCA	The UK Financial Conduct Authority
MiFID	The Markets in Financial Instruments Directive
MiFID II	The Second Markets in Financial Instruments Directive
NPPRs	The National Private Placement Regimes
Order	The Legislative Reform (Private Fund Limited Partnerships) Order 2017
PFLP	A Private Fund Limited Partnership
PRA	The UK Prudential Regulation Authority
SM&CR	The Senior Manager's & Certification Regime

Appendix A

Senior Manager's and Certification Regime

Summary

The FCA has recently published its consultation paper (which is due to close in early November) outlining the proposals for extending the Senior Manager's and Certification Regime (SM&CR), which currently only applies to banks, building societies and a few large designated investment firms, to all regulated firms in 2018. The extension will potentially bring approximately 90,000 individuals into the senior manager element of the regime (the SMR) and 65,000 into the certification regime.

The FCA's proposals are intended to ensure that the extended regime appropriately reflects the diverse business models operating in the UK market and is proportionate to the size and complexity of firms. To that end the FCA is proposing to apply a limited set of the rules to smaller firms (these firms are described as 'limited scope firms'), whilst a baseline of requirements will be applied to the majority of firms (described as 'core firms'), and additional requirements will be applied to a small number of large and high-impact FCA regulated firms (called 'enhanced firms').

Nonetheless given the fundamental changes that firms will need to make in advance of its implementation, it is widely acknowledged that they need to start preparing as soon as possible.

What is the SM&CR?

The SM&CR has a number of different aspects to it with the regime applying to staff according to their seniority in the following ways:

The **Senior Managers** element to the new regime involves:

a. The identification of senior managers performing certain certain Senior Management Functions;

b. 'Statements of Responsibilities' for the senior managers which set out their areas of personal responsibility;

c. The allocation of certain FCA prescribed responsibilities along with other key business responsibilities;

d. Firms to have in place a responsibilities map which sets out how responsibilities are distributed amongst senior managers;

e. Pre-approval to be sought from the FCA for all senior managers who are new in post with firms demonstrating that the individuals are fit and proper;

f. A grandfathering regime for existing senior managers;

g. New Conduct Rules for senior managers. In addition to the conduct rules for all staff set out below, Senior Managers should:

   i. take steps to ensure that the business of the firm for which they are responsible is controlled effectively;

   ii. take steps to ensure that the business of the firm for which they are responsible complies with the relevant requirements and standards of the regulatory system;

   iii. take steps to ensure that any delegation of their responsibilities is to an appropriate person and that they oversee the discharge of the delegated responsibility effectively; and

   iv. disclose any information of which the FCA or Prudential Regulation Authority (PRA) would reasonably expect notice;

h. A statutory requirement for senior managers to take reasonable steps to prevent regulatory breaches in their areas of responsibility (the Duty of Responsibility);

i. Increased use of enforcement against senior managers where failures occur; and

j. The designation of General Counsel or other Heads of Legal Functions as performing functions that would require them to be a Senior Manager (the FCA has previously issued a separate Discussion Paper regarding this issue).

The **Certification** aspect involves:

a. A requirement on firms to identify individuals who perform a function that could cause significant harm to the firm or its customers;

b. Individuals working in areas such as HR, legal, compliance and audit could all fall within the scope of this specific aspect of the regime (depending on their specific role);

c. Firms must certify all identified individuals as fit and proper, taking into account their (i) honesty, integrity and reputation, (ii) competence and capability, and (iii) financial soundness, both on recruitment and annually thereafter (rather than applying to the regulator for approval for these staff); and

d. The conduct rules will apply to all certificated staff, and firms will need to report on any breaches of the conduct rules by certificated staff.

Conduct Rules are high level rules which apply to all non-ancillary (e.g. not catering, security or cleaning) staff in a firm (the rules are set out at COCON in the FCA Handbook). Action can be taken against any individual who breaches the Conduct Rules no matter how junior that person is.

Firms are also under a duty to report any breaches of these rules, which require that individuals should:

a. act with integrity;

b. act with due skill, care and diligence;

c. be open and cooperative with the FCA, the PRA and other regulators;

d. pay due regard to the interests of customers and treat them fairly; and

e. observe proper standards of market conduct.

Other key aspects to the regime

In addition to the foregoing, there are other elements to the wider regime which are to be extended to other firms, and it has been proposed this could include the rules relating to Regulatory References.

Key aspects of these rules include:

a. Requesting regulatory references – firms will be required to obtain regulatory references going back six years in order to assess the fitness and propriety of candidates for roles as senior managers and certificated persons;

b. Record keeping - firms will need to keep information going back six years about staff for when the relevant staff member moves on and a reference is requested by a future employer;

c. Disciplinary proceedings – if a firm identifies possible misconduct by a member of staff then there is a greater onus upon the firm to investigate because any references it is asked to give must be fair and accurate;

d. Settlement agreements – when a member of staff leaves a firm any settlement agreement that is entered into must not prevent the firm from giving a fair and accurate reference to any future employer that would include an honest account of why somebody left and the allegations of misconduct against them; and

e. Past staff members - if a firm establishes misconduct by a former member of staff they must update their records so that any future references note whatever misconduct has been discovered.

Appendix B

The FCA'S Asset Management Market Study

The FCA published its final report setting out the findings of its Asset Management Market Study (AMMS) on 28 June 2017. The original terms of reference for the asset management market study were published in November 2015. Subsequently, in November 2016, the FCA published its interim report. This set out the FCA's provisional view on the way competition works for asset management services, the resulting outcomes for investors and its proposed remedies to address the identified issues.

While many of the remedies are only relevant to the managers of funds authorised for retail distribution, managers of private equity and alternative funds should be aware of those remedies which will have an impact on the way in which they operate, in particular the remedies relating to transparency of fees and charges.

Key findings

Having considered the feedback it received, the FCA has confirmed that the following key findings set out in the interim report are to be final:

- Price competition is weak in a number of areas of the sector;
- Despite a large number of firms operating in the market there was evidence of sustained, high profits over a number of years;
- Investors are not always clear what the objectives of funds are;
- Fund performance is not always reported against an appropriate benchmark; and
- There were concerns about the way the investment consultant market operates.

The remedies

Having concluded there are areas of weak price competition across the asset management industry, the FCA has proposed a range of remedies to seek to address these perceived weaknesses. These remedies, which will have far-reaching effects fall in to three broad areas.

i. **Provide better protection for investors to ensure value for money**

   To do this, the FCA intends to:

   - Strengthen the duty on fund managers to act in the best interests of investors and use the SM&CR to deliver individual focus and accountability;
   - Require non-AIFM fund managers to appoint a minimum of two independent directors to their boards; and
   - Introduce changes to improve fairness around the management of share classes and the way in which fund managers profit from investors buying and selling their funds.

ii. **Improve competition**

   To achieve this, the FCA will:

   - Support the disclosure of a single, all-in-fee to investors;
   - Support a consistent and standardised disclosure of costs and charges to institutional investors;
   - Recommend that the Department of Work and Pensions remove barriers to pension scheme consolidation and pooling; and
   - Chair a working group to focus on how to make fund objectives more useful and consult on how benchmarks are used and performance reported.

iii. **Improve the effectiveness of intermediaries**

To achieve this, the FCA:

- Has published terms of reference for a market study into investment platforms;
- Is seeking views on rejecting the undertakings in lieu of a market investigation reference regarding the institutional advice market to the Competition and Markets Authority; and
- Recommends that HM Treasury considers bringing investment consultants into the FCA's regulatory perimeter.

Individual accountability

It is noteworthy that the FCA highlighted the extension of the SM&CR as being a tool for it to deliver greater individual focus on key issues identified in the AMMS. Amongst other comments, the FCA noted that it was consulting on introducing a new 'Prescribed Responsibility' under the SM&CR to act in the best interests of investors including consideration of value for money. In the light of the commentary on this point it seems highly probable that this foreshadows significant regulatory action being taken against individuals in the asset management sector once the SM&CR comes into effect (from 2018).

Disclosure of costs and charges

The proposals relating to standardised disclosure of costs and charges to institutional investors will be relevant to the managers of private equity and alternative investment fund managers (AIFMs). The requirement to provide costs and charges disclosures will apply to entities which are authorised under MiFID II, as well as to AIFMs when they are carrying on MiFID business (i.e. where they manage segregated mandates or funds managed under delegation from other investment managers).

The new provisions require that all costs and charges must be shown as a single disclosure, including asset management charges, indirect costs such as transaction costs, and intermediary charges.

Whilst supportive of the changes to be brought in by MiFID II, with effect from 3 January 2018, the FCA has decided against extending the rules for standardised costs and charges disclosure to non-MiFID business. Nonetheless the FCA considers that "the information required by MiFID II will give institutional investors a clear understanding of the costs and charges that they are incurring", and that a well-designed template for this information will be likely to foster increased competition amongst asset managers.

To this end, the FCA proposes to ask an independent person to convene a stakeholder group to develop a standardised template. Following this, the FCA will work with stakeholders to ensure that institutional investors get the information they need to make effective decisions. As part of that work, the FCA may well seek to revisit the issue of disclosures to investors in alternative funds.

About the Sponsor

RPC

We deploy cross-departmental teams to advise on the structuring and raising of a wide variety of investment funds, with a particular expertise in private equity, real estate, hedge and debt funds. We also advise on fund restructurings, fund investments, carry arrangements, secondaries transactions, the setting up of management vehicles, and asset management M&A activity.

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