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In Practice

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Lending to FCA/PRA regulated businesses

In this In Practice article the authors consider the practical issues faced by practitioners and deal counterparties in structuring and executing leveraged buyout transactions where the target company is regulated by the Financial Conduct Authority and/or Prudential Regulation Authority.

BACKGROUND: THE FCA AND PRA

In the midst of the global financial crisis, the government took the decision that the much-maligned Financial Services Authority should be replaced with a bifurcated regulatory regime which ensured that larger financial institutions such as banks, building societies, insurance companies and significant investment firms had a dedicated prudential regulator that was able to take a strategic, long term approach to systemic risks to the stability of the UK financial market.

On 1 April 2013, the Prudential Regulation Authority (PRA) was created to take on this role and the Financial Conduct Authority (FCA) assumed responsibility for conduct regulation of retail and wholesale financial markets and the supporting infrastructure. The FCA was also tasked with providing prudential regulation for firms which fell outside the ambit of the PRA.

The kinds of businesses which fall within the scope of this regulatory regime will not come as a surprise to any market participants; they include:

- fund/asset managers;
- banks;
- credit institutions;
- financial and mortgage advisers;
- insurance brokers; and
- accountants.

DEAL STRUCTURING

As a general rule, a regulated target business will not be able to grant guarantees or security in support of a leveraged buyout (or at least it will be able to do so only to the extent such guarantees and security are limited in value). This is because the granting of such credit support will adversely affect its regulatory capital position, as the guaranteed/secured amount is deemed to be deducted from the amount of regulatory capital it holds, with the potential result that it no longer holds sufficient amounts to meet its minimum capital requirement. This usually results in the formation of a small "banking group" of obligor companies, where potentially only the acquisition vehicle (Bidco) is a party to the facilities agreement, and security may be limited to a share charge (and possibly a receivables charge) granted by Bidco's immediate holding company (Midco) over its shares in Bidco, and by Bidco over its shares in the Target.

It should be noted that on a number of recent transactions involving UK targets, bidders have incorporated their newcos in a Channel Islands jurisdiction, as having a Bidco incorporated outside the EEA should break the regulatory capital group (meaning debt incurred in Bidco will not have a deleterious effect on the Target's regulatory capital position).

CHANGE IN CONTROL

It is a legal requirement (pursuant to s 178 Financial Services and Markets Act 2000 (FSMA)) that prior to any change in control of a FCA/PRA regulated business, the FCA (and PRA, if applicable) have given their approval.

Therefore, all transactions whereby ownership of a FCA/PRA regulated firm is transferred to a new owner (or owners), or there is otherwise a change in control (see the definition of "controllers" below), will involve a split exchange and completion. Careful thought should be given (particularly in a competitive process) to how this will impact the deal timetable and bidders should consider putting together a financing package which is made available on a "certain funds" basis (with a "certain funds period" that lasts at least 80 working days (see below)), in order to give vendors comfort that funds are fully committed at signing and will be available for future drawing at completion.

The FCA (and, if applicable, PRA) will have 60 working days in which to carry out an assessment of a potential change in control, with such period commencing on the date on which they confirm receipt of a validly completed s 178 notice (complete with related documentation). At any time prior to the fiftieth working day, the relevant regulator may halt the assessment period in order to request further information from the parties; the making of such a request will extend the assessment period by up to a further 30 working days.

At the end of the assessment period, the regulator(s) will deliver their decision to the parties; they will either:

- grant approval to the transaction as presented by the parties;
- grant approval to the transaction subject to certain conditions; or
- refuse to approve the transaction.

If the transaction is approved, then the vendor and purchaser are free to complete within the specified approval period, which is typically three months (note that notification of completion should also be delivered to the regulator(s) as soon as possible after the deal closes). If the acquisition is rejected, then an appeal may be made.

It should be noted that the definition of "controllers" for the purposes of FSMA is considerably wider than that which is customarily seen in other areas (for example, the LMA precedent facilities agreement, which refers to 50% ownership thresholds and the ability to appoint a majority of directors) and can be as low as 10% ownership.

The controller thresholds vary by type of firm. In relation to a firm (A) which is a bank/building society, UCITS (ie retail fund) manager, investment firm under the Markets in Financial Instruments Directive (MiFID) or insurance/reinsurance undertakings, s 422 of FSMA defines a "controller" as someone who:

- holds 10% or more of the shares in A or a parent undertaking (P) of A;
- holds 10% or more of the voting power in A or P; or
- holds shares or voting power in A or P as a result of which he is able to exercise significant influence over the management of A.[1]

The controller thresholds for these firms are:

- 10% or more but less than 20%;
- 20% or more but less than 30%;
- 30% or more but less than 50%; and
- 50% or more

For all other firms except certain consumer credit firms, there is a single controller threshold of 20% (ie change in control approval is only required if a purchaser is seeking to acquire a stake of 20% or more of the shares or voting rights in the firm or a parent undertaking of the firm, or holds shares or voting power in the firm or a parent undertaking as a result of which it is able to exercise significant influence over the management of the firm). For consumer credit firms such as consumer hire firms and certain credit brokers, there is a single controller threshold of 33%.

Therefore, potential acquirers of minority stakes in authorised businesses need to be just as alive to the FCA/PRA change in control regime as those who wish to complete a more traditional takeover.

CONSEQUENCES FOR LENDERS

Lenders need to be aware of the additional complexities and delays which can occur when providing finance in connection with the acquisition of a regulated entity not only when the loan is first advanced, but also during the life of the loan. For example, a debt for equity swap entered into as part of a restructuring which involves lenders taking equity in the structure will, to the extent any lender acquires more than 10% (or 20% in certain circumstances, (see above)) of the share capital in a regulated business (or any parent company thereof), trigger an obligation to file for change in control approval before such restructuring can be completed. Similarly, any attempt by a security agent to appropriate or sell the shares in a regulated business (or any parent company thereof) upon enforcement of security will also trigger a need to seek the consent of the regulator.

Whilst we would be hopeful that the FCA/PRA would be quick to approve another FCA/PRA authorised entity (such as a bank, debt fund or professional agency/security agent services provider) as a new controller of a regulated business, there is nothing to prevent them taking the full sixty (or potentially ninety) working day time limit to grant their approval.

If they believe that the envisaged restructuring/enforcement could be detrimental to the ability of the regulated business to continue to comply with its regulatory obligations to its clients, or to meet its prudential requirements, they could reject any such proposals.

CONCLUSION

As private equity investors scour the market for the best relative value propositions, they are being increasingly drawn to sectors which have previously been considered too highly regulated and/or difficult to attract financing. We therefore expect that the relatively recent trend towards MBOs of FCA/PRA regulated businesses will continue. Whilst such businesses can appear attractive due to their high customer retention rates and contracted revenues, prudent potential acquirers and their prospective lenders should consider the key practical points raised in this In Practice article before taking the leap into regulated sectors. ■

1 Source: FCA quick reference guide: Acquisitions and the Change in Control regime.

Biog box

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