The Private Equity Review

Third Edition

Editor
Stephen L Ritchie

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This third edition of *The Private Equity Review* comes on the heels of a very good 2013 for private equity. Large, global private equity houses are now finding opportunities to deploy capital not only in North America and western Europe, where the industry was born, but also in developing and emerging markets in Asia, South America, the Middle East and Africa. At the same time, these global powerhouses face competition in local markets from home-grown private equity firms, many of whose principals learned the business working for those industry leaders.

As the industry becomes more geographically diverse, private equity professionals need guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. This review has been prepared with that need in mind. It contains contributions from leading private equity practitioners in 28 different countries, with observations and advice on private equity dealmaking and fundraising in their respective jurisdictions.

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

While no one can predict exactly how private equity will fare in 2014, one can confidently say that it will continue to play an important role in the global economy. Private equity by its very nature continually seeks out new, profitable investment opportunities, so its continued expansion into growing emerging markets appears inevitable. We will see how local markets and policymakers respond.

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

**Stephen L Ritchie**
Kirkland & Ellis LLP
Chicago, Illinois
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I OVERVIEW

Deal activity

In 2013, the UK private equity market has had the benefit of a number of positive market forces conducive to deal activity. Private equity sponsors had substantial amounts available for equity financing as a result of closings of newly raised funds and continued high levels of ‘dry powder’ (capital committed to funds but not yet spent) from previous funds. For example, Prequin estimated that as at 28 August 2013, CVC Capital Partners had US$19.6 billion of dry powder and as at 6 March 2013, BC Partners had US$6.8 billion of dry powder. In addition, debt markets were buoyant in 2013, which allowed private equity sponsors increased access to leverage and reduced financing costs. The UK market also continued to be perceived as a relative safe haven for investors (particularly those in North America) who wished to invest in Europe but limit their exposure to the ongoing uncertainties faced by the members of the eurozone. On the exit side, a resurgence of flotations of private equity-backed companies reopened an exit route for private equity sponsors.

Notwithstanding these positive market forces, the UK private equity market in 2013 suffered a 21 per cent fall in the total value of deals when compared to 2012, with the Centre for Management Buyout Research at Imperial College London (CMBOR) reporting UK deal values at €16 billion from 183 deals in 2013 compared with total UK deal values of €20.3 billion in 2012. The UK market did hold up relatively well when compared to the rest of the European market, accounting for 32 per cent of the overall value of European buyouts in 2013. A highlight in the UK was the performance of the exit market, with CMBOR reporting the total value of UK exits at €25.9 billion and that
UK exits accounted for 35 per cent of the overall exit market in Europe (exceeding the combined value of the German and French exit markets).

Therefore, while the UK private equity market has been active in 2013, it has not performed as well as might have been anticipated given the prevailing positive market forces and deal activity remains materially below pre-financial crisis levels.

ii Operation of the market

Management equity incentive arrangements

Managers are an integral part of most private equity investments as they are the people on whom the sponsor relies to operate the business on a day-to-day basis. Ensuring the right team is in place is particularly critical in the current market, where value creation is dependent on portfolio-management strengths rather than merely aggressive leverage and a strong macroeconomic environment. Making sure that the management team is properly incentivised and that its interests are aligned with those of the private equity sponsor – ensuring all are working towards a successful exit – are key considerations of any investment.

The form of equity incentive arrangements depends on a number of factors relating to the particular deal: for example, whether it is an auction process or a proprietary deal, the size of the sponsor’s stake, the growth strategy for the business and the relative importance of a particular management team to the business. Sponsors are adopting a wide range of positions, and there is an increased willingness to move away from a ‘house’ position and offer more creative or bespoke deals.

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

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

Sales processes

As deal activity slowed during the economic downturn, so the process by which assets were brought to market also changed. The highly aggressive auction processes of 2005 to 2007 were replaced with proprietary deals that had the benefit to potential buyers
of ensuring deal certainty before they were required to expend valuable time and resource on diligence. Auction processes increased in popularity again from 2011 with high quality assets trading for high multiples in competitive processes. However, there remains a material execution risk in respect of more mediocre assets, due to unrealistic price expectations and an increased scrutiny by buyers of business plans and growth assumptions. Therefore for a significant part of the market, competitive auctions are an aspirational rather than a guaranteed exit route.

Vendor nervousness around execution risk has resulted in it becoming increasingly common for sales processes to begin with a pre-auction phase. This approach allows vendors to test the appetite of a carefully targeted buyer pool without alerting the wider market to the asset’s availability.

Sales processes have also been impacted by the surge in demand for initial public offerings of private equity backed companies. Private equity managers are increasingly considering the public markets as an alternative to a sales process, whether exclusively or as part of a dual-track strategy, when assessing exit opportunities. According to *Private Equity News*, Terra Firma ran a dual-track exit process with Infinis before opting for an initial public offering and Doughty Hanson did the same with Hellerman Tyton.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

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

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

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

An investor will be concerned with ensuring that the documents properly contemplate any future exit and, in particular, that the investor will be able to offer up to 100 per cent of the company to a buyer. It will therefore require ‘drag-along’ rights enabling it to force other shareholders to sell their shares to a third party in the event that those other shareholders are not willing sellers; however, sponsors – and purchasers – prefer consensual exits, and drag-along rights are generally only used as a last resort.

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

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

Before attempting to implement any alteration to the share capital generally or the rights attaching thereto, a majority shareholder should consider whether such an alteration could also constitute an amendment to any class of shares held by the minority. For a variety of reasons (including the need to be able to compulsorily acquire the shares of a leaving manager), the sponsor and management will almost always hold different classes of shares. Where a proposed amendment will affect the rights attaching

2 [1900] 1 Ch 656.
3 [1951] Ch 286.
to a particular class of share, it cannot be approved except by the holders of a 75 per cent majority of shares in that class or in accordance with any specific provision set out in the articles of association of the company.

**Duties owed by a director**

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

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

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

c. to exercise independent judgement;

d. to exercise reasonable care, skill and diligence;

e. to avoid conflicts of interest;

f. not to accept benefits from third parties; and

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

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

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

Section 175 of the 2006 Act requires directors to avoid situations in which they have, or can have, a direct or indirect interest that conflicts, or may possibly conflict, with the interests of the company for whom they act as director. Although there is no definition of ‘interest’ or ‘conflicts of interest’, it is generally accepted that being an investor director of a portfolio company is a potential conflict situation for the purposes of the 2006 Act. One example of a conflict that could arise is if the board is required to vote on a proposal to allot additional shares to the private equity investor. It is in the interests of the sponsor to subscribe for shares at as low a price as possible, whereas the company’s interests are clearly best served by obtaining the highest price possible for the shares.

This duty is not infringed if the relevant matter has been authorised by the board of the company. The board is empowered to authorise a conflict of interests:

a. automatically in the case of a private company incorporated on or after 1 October 2008, provided nothing in the company’s articles invalidates it; or
in the case of a private company incorporated before 1 October 2008, either:

- by incorporating the necessary authorities in the company’s articles of association by special resolution; or
- by an ordinary resolution of the members that authorisation may be given by the board of directors (which is administratively simpler than amending the articles).

In the case of an acquisition effected using a newco, the articles should be drafted to ensure that the investor director will not be in breach of Section 175 of the 2006 Act by reason simply of being the private equity shareholder’s representative on the board. In the case of an existing investment, sponsors have typically undertaken an exercise in the period since the 2006 Act came into force in 2008 to ensure that the articles of their portfolio companies are amended to deal with this issue, but this should be addressed if it has not already been dealt with.

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

The Bribery Act 2010

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

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

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

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

Without proof of the required intention [to obtain or retain business or an advantage in the conduct of business for the funds or the manager], liability will not accrue through simple corporate ownership or investment, or through the payment of dividends or provision of loans.
It therefore seems very unlikely (but not impossible if, for example, a court was minded to interpret the legislation widely to make a high-profile example of a private equity house) that bribery in the portfolio would give rise to any criminal liability for the funds that owned the portfolio company or the manager managing or advising those funds.

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

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

The SFO has stated that it ‘intends to use the civil recovery process to pursue investors who have benefited from illegal activity’ and has signalled an intention to tackle in particular ‘institutional investors whose due diligence has clearly been lax’ and who ‘have the knowledge and expertise’ to conduct appropriate levels of due diligence to satisfy themselves that the company in which they are investing is not involved in corruption.

In some respects, this stated intention to hold shareholders responsible for their investment decisions represents an extension of the concepts contained within Section 7 of the Bribery Act, which, as discussed above, makes commercial organisations responsible for bribery undertaken by persons associated with them. The real concern, however, is that Section 7 allows for companies to defend themselves against offences of bribery whereas POCA sets out a strict test for liability that is not affected by a person’s behaviour – assets either derive from the proceeds of crime, and are therefore liable to be recovered, or they do not. It is therefore difficult to see how an investor could take steps to protect itself, however sophisticated its due diligence processes and whatever steps it took to monitor its investment. It will be interesting to see whether the SFO is successful.
in obtaining any further orders against shareholders and, if so, whether the circumstances of those cases shed any more light on the SFO’s expectations of investors.

III YEAR IN REVIEW

i Recent deal activity

As previously noted, whilst the UK private equity market has led the way in Europe in 2013, its performance when compared with 2012 and in the context of the positive market forces present in 2013 has been underwhelming.

A prominent theme was the return of private equity-backed companies to the public markets. 2013 included the flotations of Countrywide (backed by Apollo, Oaktree and Alchemy), Esure (backed by Penta Capital), Hellermann Tyton (backed by Doughty Hanson), Partnership Assurance (backed by Cinven), Infinis (backed by Terra Firma) and Foxtons (backed by BC Partners). One of the largest flotations was that of Merlin Entertainments (backed by investors including Blackstone and CVC Capital Partners) in November 2013 at €3.8 billion.

In relation to buyouts, high-profile transactions included the buyout in January 2013 of B&M retail by Clayton, Dubilier & Rice for €1.1 billion, and the €1.1 billion sale by Doughty Hanson of Vue Entertainment to OMERS Private Equity and Alberta Investment Management Corporation. The Vue Entertainment transaction illustrates the interest of North American acquirers in UK buyouts as a means of allowing exposure to European assets but with a level of protection from the eurozone’s volatility due to the relative safety of sterling and the UK.

As was the case in 2012, the fragile state of UK retailers continued to attract private equity investors to the sector with capital being deployed to take control of distressed retailers, often out of insolvency. Prominent transactions included Hilco’s acquisition of HMV, Gordon Brothers’ acquisition of Blockbusters and Sun European Partners’ acquisition of Dreams.

Another feature of 2013 was the number of recapitalisations undertaken by private equity sponsors which were facilitated by the buoyant debt markets and allowed private equity sponsors to return a level of funds to their investors. For example, in September 2013 thetrainline.com, owned by Exponent Private Equity, completed a £190 million dividend recapitalisation.

ii Financing

2013 saw significant improvement in the availability of bank liquidity and willingness to lend. At the same time, strong financing competition emerged due to the increasing inroads being made by direct lenders in the mid-market space, the continued strength of high-yield bonds as a source of acquisition financing, refinancing in the mid- and upper-market, the availability of US-sourced loan financing in European markets and the resurgence of European CLOs (€7.4 billion of issuance in 2013, versus zero in 2012).5

5 S&P Capital IQ LCD.
As a result there was increased leveraged loan supply in 2013 and a corresponding improvement in debt-financing economics and terms for sponsors.

In consequence, sponsor-backed European leveraged loan volumes reached their highest level since 2008 (at €45.8 billion, versus €67.4 billion of overall leveraged loan supply), whilst European high-yield debt issuance increased further over 2012’s levels (to a record of €70.4 billion). Unsurprisingly, these developments have been accompanied by falling loan margins, record-low bond yields, increased tolerance of leverage, lower equity tickets and the reappearance of sponsor/borrower-friendly terms (some deals with a US element seeing the re-emergence of covenant-lite or covenant-loose packages).

Strong vendor pricing expectations and equity valuations may be responsible for the large part played in these numbers by opportunistic refinancings and dividend recapitalisations by sponsors. The repricings and dividend recapitalisations which featured for sponsors in the upper end of the market during 2012 have now more thoroughly permeated the market. Some 58 per cent of new leveraged lending in 2013 was accounted for by refinancings and recapitalisations, in contrast to the 40 per cent which was related to acquisitions and buyouts. Dividend recapitalisations were split fairly evenly between high-yield and leveraged loans, with distributions surpassing anything seen since 2008 and totalling around €6.1 billion.

In the leveraged loan market, club deals not planned to be subject to general syndication remain common in mid-cap bank financings. Arranger groups once again commonly appear in larger underwritten deals at the upper end of the market, where jumbo deals (often financed through a combination of high-yield and bank debt) are again being done.

‘Alternative’ direct lenders, such as insurers and pension funds in certain asset classes (notably real estate and infrastructure), and particularly specialist debt funds such as Haymarket Financial, Ares Capital, GE, ICG, Babson, BlueBay and Metric Capital across the market, have continued to see strong growth and increased their share of mid-market lending. Such loans are often structured as unitranche non-amortising term facilities (effectively a blended senior and mezzanine offering) coupled with a working capital facility from a bank lender – typifying the direct lenders’ willingness and ability to embrace innovation.

Mezzanine debt proper continues to feature in few deals, and has not seen a revival in its fortunes more generally despite a small number of large standout acquisition-financing deals which saw repricings in 2013. New mezzanine borrowing recorded during the year reached €450 million. However, some observers take the view that increased tolerance of senior lenders for higher leverage multiples, plus lower bank pricing, have begun to encroach upon the upper levels of the unitranche debt market and it remains to be seen whether this will encourage a mezzanine uptick (particularly in the case of deals too small to tap the high-yield market).
Other borrowers continue to agree with their existing bank financiers to amend and extend existing facilities in return for some or all of additional fees, increased pricing and financial covenant re-sets. Unsurprisingly, given the overall blend of various senior, debt capital market and alternative funding sources, second lien facilities remain scarce.

The high-yield bond market is frequently susceptible to investor sentiment around macroeconomic issues, but continues as a strong source of acquisition financing and in particular refinancing, driven by risk appetite and search for yield among high-yield investors. Borrowers disinclined or unable to access loan financing have turned willingly to lock in bond debt, whether as acquisition financing bridged by (ideally) undrawn bank facilities typically provided chiefly by the bond underwriters or funded by issuance directly into escrow pending acquisition close, or via bond-for-loan refinancings which also offer the prospect of sponsor equity returns. High-yield bonds typically form part of a bank-bond financing structure, with a super senior working capital facility provided by one or a small group of banks, often relationship banks.

For increasing numbers of borrowers, access to the deep liquidity in the US loan markets has been possible, resulting in hybrid cross-border European and US financing structures. These feature more frequently in the upper end of the market than in the mid-market, possibly due in part to their complexity (including in relation to differing expectations from US and European lenders as to security and intercreditor arrangements). Notwithstanding the strength of the high-yield markets, which continue to challenge the position of loan financing, investor demand for such loan products drives pricing that is competitive with bond debt and oversubscription has frequently occurred (with consequent reverse flex improvements to terms).

Some market commentators are of the view that if and as the high-yield markets overheat, yields are driven still lower and bank strength returns in Europe, the balance between loans and bond debt may again shift. Given the strength, complexity and multipolarity of current debt markets, this remains to be seen. Nevertheless, it seems likely that banks will retain a pivotal position in large and complex capital structures combining multiple classes and layers of financing.

As far as legal terms for acquisition loan financing and refinancings are concerned, these have seen easing at all levels of the market – significantly so at the upper end. Cross-border European and US facilities continue their trend for increasingly sponsor-friendly terms. ‘Certain funds’ and equity cure provisions continue as established features of European private equity financings, and sponsors’ counsel continue to draft term sheets and provide first draft facility documentation in some cases. LIBOR and EURIBOR floors (whether at zero or above) feature frequently in new loan facilities, and have become a standard feature of US financings.

Opening leverage multiples have continued to increase, up to and above five to five-and-a-quarter times, but are typically lower in smaller transactions. Original issue discounts also feature, but have often been scaled back where a reverse flex is exercised.

Pricing is dependent on the nature of the financing available, but senior bank debt has seen margins fall to around 4 per cent to 4.5 per cent for amortising facilities and 25 to 50 basis points higher for non-amortising debt. Mezzanine cash pay margins tend to be around 8 per cent to 10 per cent over cost of funds. Unitranche margins tend to start at around 7 per cent (with a LIBOR floor of one per cent), moving upwards on a transaction- and credit-specific basis. As for arrangement fees, these may start from as...
low as 3 per cent for senior debt for good quality credits, but fees of around 4 per cent are more typical, and higher for lower quality credits where lenders expect correspondingly enhanced pricing.

In overall terms, private equity debt financing availability is strong. High-yield financing has continued to provide significant liquidity in the acquisition financing and refinancing space; bank debt for acquisitions is now far more readily available in Europe as well as from the US; direct lending has become an established feature of private equity capital structures; and payment-in-kind notes have re-emerged as a sponsor tool to increase overall leverage.

###iii Key terms of recent control transactions

Key terms of private equity control transactions remain largely unchanged with private equity sellers focusing on the ability to return sales proceeds quickly to their fund investors and execution risk. Consequently, private equity sellers seek to limit their obligations and exposure under the transaction documentation and avoid conditionality.

Warranty insurance has become an increasingly common way of limiting sell-side exposure while providing a buyer with meaningful recourse for breaches of warranty.

###iv Exits

The private equity exit market in the UK has performed well in 2013 with the total exit value reaching €25.9 billion. Private equity managers benefited from the return of market demand for the flotation of private equity portfolio companies in the UK. This has been a positive development as it has reopened flotations in the UK as a viable route to value realisation by private equity managers alongside trade sales and the secondary market. The CMBOR reports that secondary transactions held up well in 2013 and continued to be a very popular exit route for private equity managers. However, the CMBOR’s research suggests that engagement with corporate acquirers remains challenging.

It should, however, be noted that the UK exit market continues to underperform when compared with the period prior to the global financial crisis (for example, the CMBOR recorded the total exit value for 2006 at €38.8 billion).

###IV REGULATORY DEVELOPMENTS

####i Overview of the regulatory environment

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

- **a** advising on investments;
- **b** arranging transactions in investments;

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9 Financial Services and Markets Act 2000 (FSMA), Section 19.
Most UK sponsors therefore need to obtain FCA authorisation in order to carry out their investment activities. With effect from 1 April 2013, the functions of the former regulator (the Financial Services Authority (FSA)) were split, with responsibility for the prudential supervision of systemically important financial institutions transferring to the PRA within the Bank of England. The FCA took over the FSA’s legal entity and is now responsible for supervising all regulated firms from a conduct-of-business perspective and firms not supervised by the PRA from a prudential perspective. The vast majority of independent private equity houses previously regulated by the FSA are now supervised by the FCA for both conduct and prudential matters.

The European Markets in Financial Instruments Directive (MiFID) also applies in the UK. MiFID has been implemented in the UK as part of the handbook of rules and guidance published by the FCA (the FCA Rules) and is therefore an overlay on top of the UK domestic regime. MiFID provides for the regulation of the provision of specified ‘investment services’ by ‘investment firms’ within EU Member States. The scope of ‘regulated activities’ requiring regulation under the UK domestic regulatory regime is broader than the scope of MiFID in certain areas and it is possible for a firm to be subject to UK domestic regulation but fall outside the European regulatory regime. Depending upon fund structures, many private equity sponsors are able to rely upon an exemption from MiFID for the operators of funds, while still remaining subject to an obligation to obtain FCA authorisation.\(^\text{10}\) However, some sponsors do fall within the scope of MiFID. Whether or not a regulated firm is subject to MiFID has consequences for the detail of the compliance regime with which a firm must comply and, in particular, the amount of regulatory capital required. MiFID is currently under review at a European level, and a revised regime (MiFID II)\(^\text{11}\) has been proposed (see subsection vi, infra). However, MiFID II is unlikely to fundamentally alter the scope of the European regulatory regime as it applies to private equity sponsors.

The exact regulated activities that a particular sponsor may need to be authorised to undertake is dependent upon the precise scope of activities to be undertaken in the UK. For example, where a UK sponsor utilises an offshore fund structure and does not have a discretionary investment management mandate in respect of the private equity fund or funds to whom its services are provided, it will not be treated as undertaking the regulated activity of managing investments. Instead, such a firm will be viewed as an ‘adviser’ or ‘arranger’ for regulatory purposes.

The UK regulatory regime also restricts the marketing of securities, which can potentially impact upon presentations (whether in writing or oral) issued in relation

\(^{10}\) MiFID, Article 2(1)(h).

to transactions. A person may not issue a ‘financial promotion’ without being FCA authorised, unless an exemption is available.\textsuperscript{12} A ‘financial promotion’ is widely defined as an invitation or inducement to engage in investment activity, such as the buying or selling of shares.\textsuperscript{13}

Depending upon the facts, it is also possible that a non-UK sponsor may undertake regulated activities in the UK when engaging in UK transactions. Simply making a UK investment (and even attending transaction meetings in the UK) is unlikely, of itself, to bring such a sponsor within the UK regulatory regime.\textsuperscript{14}

Since the global financial crisis, financial services regulation has come under intense scrutiny, and a number of changes have occurred or are being proposed. The FCA has adopted a more intrusive approach to supervision of regulated firms, including private equity sponsors.

\textbf{ii \quad FCA authorisation process}

An application for FCA authorisation should be made by the entity within a sponsor’s group that will undertake regulated business in the UK. In order to become FCA authorised, a firm must submit an application in a prescribed form to the FCA.\textsuperscript{15} A sponsor must also pay an application fee to the FCA.

However, due to the level of detail involved in an application for FCA authorisation, in practice sponsors frequently seek advice from external legal counsel or compliance consultants, or both, and such costs will also need to be budgeted for as part of the application process. Many sponsors also appoint a firm of accountants to advise them in connection with regulatory capital issues and to prepare the detailed financial forecasts that must be submitted as part of an application for FCA authorisation.

The FCA authorisation process can be lengthy, and is currently likely to take between three and nine months from inception to obtaining authorised status from the FCA, depending upon whether a sponsor is proactive in putting an application together and also the complexity of the sponsor’s business (and structure) from a regulatory perspective. Legally, the FCA has six months from the date on which an application that the FCA considers to be complete is submitted to it in which to determine an application (or 12 months from the date on which it receives an incomplete application).\textsuperscript{16}

The Alternative Investment Fund Managers Directive (the AIFM Directive) came into force in July 2013, subject to transitional provisions which allow many existing private equity sponsors to postpone compliance with its substantive requirements until

\begin{itemize}
  \item \textsuperscript{12} FSMA, Section 21.
  \item \textsuperscript{13} Id.
  \item \textsuperscript{14} The FCA has published guidance on the link between regulated activities and the UK in Chapter 2.4 of the Perimeter Guidance sourcebook of the FCA Handbook (available at http://fsandbook.info/FS/html/FCA/). Section 418 of FSMA extends the ordinary meaning of ‘in the UK’ for these purposes.
  \item \textsuperscript{15} The application form for FCA authorisation is available at www.fca.org.uk/firms/about-authorisation/authorising-soloregulated-firms.
  \item \textsuperscript{16} FSMA, Sections 55V(1) and 55V(2).
\end{itemize}
July 2014. Private equity houses with a presence in, or seeking to market into, the UK (or elsewhere in the EU) should by now have assessed the extent to which it will impact their business and be well advanced in their implementation planning. The AIFM Directive is discussed in subsection v, infra.

iii Ongoing obligations

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

a must maintain ‘regulatory capital’ equal to or in excess of a figure determined in accordance with detailed rules. Firms that are within the scope of MiFID must additionally undertake an ‘internal capital adequacy assessment process’ whereby the risks to which a firm is exposed are calculated. Firms which are subject to the AIFM Directive must also comply with its regulatory capital requirements;

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

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

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

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

f must maintain a policy to monitor and deter any conflicts of interest. From a transactional perspective, the most important consequence of this is that an authorised firm is under a duty to identify and adequately manage actual or potential conflicts of interest and to disclose such conflicts under certain circumstances;¹⁷

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

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

iv FCA consent to changes in control

Where a private equity sponsor purchases an interest in an investee group that itself contains one or more FCA-authorised firms, it must first obtain FCA consent to the transaction, unless the interest to be acquired is sufficiently small as to avoid the sponsor becoming a ‘controller’ after the transaction. For these purposes, control is usually triggered by reference to a 10 per cent share capital or voting rights (or both, or other significant influence) test, although for target firms not subject to MiFID (or the AIFM Directive), the applicable threshold is instead 20 per cent.¹⁸

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¹⁷ Chapter 10 of the Senior Management Arrangements, Systems and Controls Sourcebook of the FCA Rules.

¹⁸ FSMA, Part XII.
The AIFM Directive

The AIFM Directive imposes obligations on an EU manager of any ‘alternative investment fund’ in one or more EU Member States and also restricts the marketing of funds. The AIFM Directive (among other requirements):

- imposes more stringent regulatory capital requirements than those currently applicable;
- mandates the disclosure of certain key information to investors and regulators;
- requires the use of depositaries (essentially, custodians) to hold fund assets (i.e., interests in investee companies);
- imposes requirements in relation to remuneration – sponsors are required to adopt remuneration policies that promote sound and effective risk management and do not encourage risk-taking that is inconsistent with the risk profiles, fund rules or instruments of incorporation of the funds that the sponsors manage;
- restricts the outsourcing of key functions by managers, except where detailed outsourcing rules are complied with;¹⁹ and
- requires registration of fund documentation with the relevant regulator.

Subject to transitional provisions (including, importantly, the continuation of the UK’s existing private placement marketing regime for at least the medium term), the AIFM Directive also restricts the marketing of alternative investment funds in the EU by sponsors based outside the EU unless they comply with detailed ‘third country’ provisions. These require a non-EU manager to be regulated by a regulator that has signed a memorandum of understanding agreeing to impose certain requirements contained in the AIFM Directive on such investment managers. However, alternative investment fund managers regulated under the AIFM Directive may make use of ‘passport’ rights to market across Europe, subject to complying with registration requirements.

The primary obligations under the AIFM Directive entered into force in July 2013. However key transitional provisions allow many existing managers to postpone compliance with the AIFM Directive’s substantive requirements until after July 2014.

Other forthcoming developments

The Solvency II Directive²⁰ will also have an (albeit indirect) impact upon many sponsors. Solvency II will now not come into force until January 2016 following the passing of the second ‘Quick Fix’ directive²¹ as firms and regulators alike were not ready for Solvency II to come into force. The implementation date has slipped a number of times from the original 1 January 2012 target date. Prior to Solvency II coming into force, and due to the numerous delays that have beset the project, the European Insurance and Occupational Pensions Authority (EIOPA) has released preparatory guidelines which firms should begin to comply with to ensure that they are ready for when Solvency II does come into force. On 21 October 2013, the PRA published a consultation paper on a draft

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¹⁹ Directive 2011/61/EU.
²⁰ Directive 2009/138/EC.
²¹ Directive 2012/23/EU.
supervisory statement for all firms within the scope of Solvency II. The statement sets out the PRA’s expectations of firms in relation to the EIOPA guidelines for the preparation of Solvency II. The guidelines cover key areas which EIOPA considers fundamental to ensure effective preparation and convergence in preparations for Solvency II, starting from 1 January 2014 and coming into force on a staggered basis.

Solvency II will require insurance firms to risk-weight their investments and only permit them to treat certain percentages of assets as capital depending on the risk weighting attributed to the asset class to which such assets belong. For these purposes, private equity has been placed in an ‘other equities’ category, with a higher risk weighting than publicly quoted equities, although in certain circumstances, insurers may be able to adopt a ‘look through’ approach to enable them to treat a holding in a fund as a holding in the underlying assets possibly leading to a more benign capital treatment. In the absence of structuring solutions, this is likely to have a knock-on impact on insurance sector investors’ appetite to participate in the private equity asset class.

The provisions of the proposed revised Institutions for Occupational Retirement Provision (IORP) Directive,22 which would have imposed a similar regime to Solvency II on providers of occupational pensions are now unlikely to proceed.23 However, we understand that domestic regulators within Europe are considering implementing some of those proposals. In the UK, The Pensions Regulator is consulting on a new draft Code of Practice on the funding of defined benefit pensions schemes to replace the existing Code of Practice issued in 2006. This includes proposals to restrict trustees from taking funding or investment risk unless the employer can fund the gap should those risks materialise. This may, if implemented, dampen some defined benefit pension funds’ appetite for making private equity investments, although it does not contain the ‘hard’ solvency provisions mandated under the original Pillar I proposals of the IORP directive.

MiFID is currently under review at European level. As part of the review exercise, the European Commission has proposed the MiFID II package of reforms, comprising a directive to be implemented into national law and a directly applicable regulation. Although its impact is primarily focused on more liquid investment activity than private equity investment, MiFID II will impact the compliance framework of those private equity houses currently subject to MiFID (see subsection i, supra). MiFID II includes provisions on:

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

22 The existing IORP Directive is 2003/41/EC.
23 European Commission MEMO/13/454.
V OUTLOOK

While it would be premature to say that the UK private equity market has recovered from the impact of the global credit crisis given its performance over the last 12 months, there are a number of positive factors which should support private equity deal activity in the UK in the short to medium term, provide a sense of optimism in the market and instil a level of confidence in both sellers and acquirers of private equity assets. These factors include:

a at a macroeconomic level, improving economic prospects in the UK;
b the availability of leverage on competitive terms;
c the positive reception of private equity-backed companies by the public markets in 2013, which should continue into 2014 and result in further initial public offerings of private equity backed companies;
d the significant levels of dry powder committed to private equity funds by investors (both to historic funds and newly raised funds), a significant proportion of which relates to older funds and needs to be deployed before the expiry of increasingly proximate investment periods, if the relevant private equity managers are to make the most of the funds that they have raised;
e pressure on private equity managers to dispose of assets and return capital to their investors ahead of fundraisings, so as to: (1) demonstrate an ability to create and realise value for their investors; and (2) free up capital for investors to allow investors to commit to new funds while staying within their asset allocation parameters (many investors depend on distributions from their private equity investments to fund a significant proportion of their commitments to new private equity funds); and
f the fact that the UK remains an attractive economy for international investors seeking exposure to the eurozone.

Optimism for the private equity market as a whole is also reflected in investor sentiment with Coller Capital’s winter 2013 ‘Global Private Equity Barometer’ indicating that 37 per cent of investors are planning to increase their target allocation to private equity over the next 12 months (compared with only 14 per cent who plan to reduce it) and that many of the world’s largest investors are intending to increase the size of their private equity teams. Furthermore, Coller Capital’s research reveals that 86 per cent of investors are forecasting annual net returns of over 11 per cent across their private equity portfolios during the next three to five years.
Appendix 1

ABOUT THE AUTHORS

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Stephen Drewitt joined the firm in 1993 and became a partner in 2002. He specialises in private equity, acting predominantly for private equity sponsors. He has developed particular expertise in relation to minority investments and private equity investment in companies in the financial services sector. Clients for whom he acts include 3i, OpCapita, Goldman Sachs, Kester Capital, the Royal Bank of Scotland plc, Phoenix Equity Partners, Darwin Private Equity and Silverfleet Capital.

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