UKLA Technical Note

Related party transactions – Modified requirements for smaller related party transactions

Ref: UKLA / TN / 308.2

LR 11

LR 11.1.10R(2)(b) requires a premium listed company to obtain a written confirmation from a sponsor that the terms of the proposed transaction or arrangement with the related party are fair and reasonable as far as the shareholders of the premium listed company are concerned. If we requested to see this confirmation, ~~LR 1.3.1R provides that this confirmation~~ it should be provided to us as soon as possible, as required by LR 1.3.1R. We would only use this confirmation in the exercise of our statutory functions, and it is inappropriate and unnecessary to include language in a confirmation ~~which~~ that seeks to limit our use of it. For the same reason, ~~W~~we ~~also~~ believe it is unnecessary to include third-~~-~~party disclaimers, as the purpose for which ~~they~~ the sponsor's confirmation is provided to the FCA is clear.

The confirmation provided by the sponsor under LR 11.1.10R(2)(b) is an important shareholder safeguard. Unlike with a larger transaction, shareholders do not have the opportunity to vote on smaller transactions. We rely on the sponsor to undertake sufficient work to ~~come to~~reach a considered opinion~~, and~~; there is no need to explain in the confirmation how that opinion was reached. On the contrary, we do not expect to see explanations of the basis of preparation, as it could be seen to limit the validity of the confirmation. Instead, a clean confirmation, tracking the wording used in LR 11.1.10R(2)(b), should be given.

Please note we will still need to have discussions about the substance of the transaction contemplated, ~~and~~ as well as the correct classification under the class tests, before the final letters are submitted. We would also like to take the opportunity to highlight that a signed, final confirmation needs to be in place before the premium listed company enters into the relevant transaction.

UKLA Technical Note

Related party transactions – Content of RIS announcement

Ref: UKLA / TN / 309.2

LR 11

Premium listed companies are reminded that LR 11.1.10R is a concession that allows them to complete a related party transaction without a shareholder vote. The disclosure required by LR 11.1.10R(2)(c) can often be the only disclosure made to shareholders in respect of the transaction. Therefore, when disclosing the transaction (through the required RIS announcement), it is essential that premium listed companies take reasonable care to ensure that the relevant disclosure is not misleading or confusing (as ~~set out~~ ~~in~~ required by LR 1.3.3R), and that the transaction is easily identifiable as a related party transaction under the Listing Rules.

UKLA Technical Note

Investment management agreements and independence of the board

Ref: UKLA / TN / 405.1

LR 15.2.19R and LR 15.4.7AR

In CP12/25, we consulted on amending LR 15 and subsequently introduced rules which state that the board of a premium listed closed-ended investment fund must be able to effectively monitor and manage the performance of its key service providers, such as the investment manager, both at admission and on an ongoing basis (LR 15.2.19R and LR 15.4.7AR).

In CP12/25, we highlighted our continued belief that it is important that the board acts as an important counterbalance to the investment manager (paragraphs 8.5 and 8.6). Specifically, we stated that we expected boards to ensure that appropriate contracts with key service providers are in place at admission, and to ensure that they are in a position to take action if the contractual provisions are breached or they are no longer in the best interests of shareholders (see paragraphs 1.34 and 8.14 of CP12/25 and Handbook Notice No 4, July 2013). Whilest this issue was highlighted in the context of the AIFMD, the new rules built on an existing concept articulated as part of previous FSA policy work (the Investment Entities Listing Review).

The purpose of an independent board is to offer challenge, including to key service providers such as the investment manager, and to safeguard shareholders' interests. Traditionally, the board ultimately had the ability to terminate the management agreement and appoint a new manager if the performance of the existing manager was found to be unacceptable. Of course, such a termination may be at a cost, and, depending upon the nature of the fund's investments, there may commonly be a period of initial investment, during which the ability to cancel any agreement would be very limited.

However, we have seen new applicants with investment management agreements that either:

- only allow the fund's board to terminate the agreement if the fund is wound up at the same time, or that;

continue in perpetuity or for an exceptionally long period of time that is unusually long compared to other funds with similar investment policies, with termination costs that are essentially prohibitive or where termination is only permitted following a shareholder vote.,; andor

-
- agreements withhave termination fees or other significant termination penalties that are essentially prohibitive.

Clearly, the challenge provided by an independent board will only lead to the dismissal of an investment manager in the most extreme cases. In addition, an investment manager will normally be subject to a number of regulatory and fiduciary duties that will govern its relationship with the fund. It is unclear to what extent the ultimate ability to cancel an agreement affects discussions between the fund's board and its investment manager.

LR 15 does not prescribe specific provisions for investment management agreements; and generally, we would not seek to involve ourselves in what we regard as essentially as a commercial contract that needs to be appropriate for a particular fund.

However, boards should be mindful of whether the terms of an agreement are such that their ability to act independently and provide appropriate challenge could be fettered. In the case of a new applicant, we would expect the fund's sponsor to be able to articulate how the board is able to meet the requirements of LR 15.2.19R (and, in due course, LR 15.4.7AR) in light of particularly onerous or unusual terms termination provisions in the investment management agreement that are particularly onerous or unusual in the context of the fund's investment policy. We may question a new applicant's ability to comply with these rules where the terms of an investment management agreement are such that they could prevent a board from terminating an investment management agreement or contain terminations provisions which are particularly onerous or unusual when compared to funds with similar investment policies. We expect that this will be an issue only in the most exceptional cases. We encourage sponsors to engage with us at an early stage if there is a concern that this may apply to a new applicant.

As a separate matter, the prospectus should describe any onerous or unusual provisions relating to termination of the investment management agreement, including the potential impact on the fund. However, we emphasise that disclosure is not of itself sufficient to satisfy any concern about eligibility.

UKLA Technical Note

Closed-ended investment funds with multiple share classes

Ref: UKLA / TN / 407.1

LR 15.2.7R, LR 15.2.8G, LR 15.4.1AR, LR 15.4.2R and LR 15.4.8R

A closed-ended investment fund must, at all times, invest and manage its assets in a way ~~which~~ that is consistent with its objective of spreading investment risk and in accordance with its published investment policy (LR 15.4.2R). The investment policy required under LR 15.2.7R and LR 15.4.1AR is a written account of how the fund invests and manages its assets. A fund adopts self-imposed limits appropriate to its own investment strategy. The investment policy effectively acts as a risk~~-~~management process, limiting and defining exposures a fund will have in relation to asset allocation, risk diversification and gearing. As set out in LR 15.2.8G (applied on an ongoing basis by LR 15.4.1AR), the published investment policy should be sufficiently precise and clear to enable an investor to assess the investment opportunity and identify how the objective of risk spreading is to be achieved. It should also enable ~~an~~ investors to assess the significance of proposed changes of the investment policy, some of which may require their consent (LR 15.4.8R).

LR 15 is designed to be compatible with a wide range of investment strategies and styles. As a fund can list more than one share class, an investor can invest in different classes of shares in the same fund. The investor must be able to assess the investment opportunity offered by each share class and identify how the objective of risk spreading is achieved in that share class. An investment policy that is sufficiently precise and clear should enable an investor to do so. When an investment policy is amended, a shareholder should be able to understand how that affects the particular share class invested in, if applicable.

Funds with multiple share classes vary, as do their investment policies.

For example, where a new class of shares (usually designated as C shares) is issued which is ultimately intended to convert into an existing class, we will commonly see provision for the new money raised from the C shares to be invested in a separate pool of assets, but under the same investment policy as the existing shares.~~investment policies that provide for conversion~~ The C shares will convert ~~upon~~when a ~~certain~~

specified level of investment of the funds attributable to the new class has been reached.~~and include a statement that,~~ ~~p~~Post-~~-~~conversion, shareholders will be exposed to ~~a~~ the broader portfolio and it is usually not necessary for the investment policy to have separate diversification limits for the C shares.

For VCTs with multiple share classes, the investment policy may recognise the different point of investment to take into account tax legislation. Where there are multiple share classes, for example as in some VCTs or protected cell companies, ~~W~~while we do not seek to be prescriptive in how ~~a~~the fund presents its investment policy, we would expect it to be sufficiently precise and clear to enable an investor to understand how funds are invested, and that, in substance, it ensures that a spread of investment risk is achieved for each share class. We would be concerned if there are permanent share classes ~~which~~that invest in discrete pools of assets that are not diversified.

UKLA Technical Note

Eligibility of closed-ended investment funds

Ref: UKLA / TN / 408.1

LR15.2

LR 15 was introduced in 2007 and is designed to cater for a wide range of investment strategies and methods of investment. It opened up listing to a broader range of funds, including private equity and hedge funds.

Key concepts in LR 15 include:

- the requirement to have a defined investment policy which can only be changed materially with the consent of shareholders;
- the obligation to have a board independent from the fund manager;
- the need to spread investment risk; and
- a prohibition from conducting significant trading activity.

These concepts apply irrespective of the nature of the asset class invested in or the fund's strategy.

Since then, the market has taken advantage of the flexibility offered by LR 15 and we have seen increasing numbers of funds of a more complex nature, in terms of structure, asset class and investment management, including funds which only hold controlling stakes in their investments.

In the context of assessing the eligibility of a new fund for listing, the majority of our time is spent considering the last two ~~elements~~ items above. We are particularly concerned to ensure that the entities we list under LR 15 are genuinely funds, rather than trading companies which should more appropriately consider a listing under LR 6 or LR 14.

We frequently engage in discussions with applicants, advisers and sponsors regarding the boundary between an entity that is eligible for listing under LR 15 and one that is not. This guidance sets out some of the key considerations that we take into account when determining whether an applicant can be considered to be a closed-ended

investment fund, bearing in mind the eligibility requirements set out in LR 15.2.2R and LR 15.2.3AR.

The guidance is designed to be asset class and strategy neutral. It is not intended to set out an exhaustive list of factors and not every factor will be relevant in every case, but the intention is to make our thinking process more transparent in the less obvious eligibility cases.

Spread of investment risk ~~– LR 15.2.2R~~

One of the key eligibility requirements under LR 15 is that the applicant must spread investment risk. A listed fund should be a risk-~~–~~spreading vehicle that offers investors diversified exposure to an asset~~s~~ class ~~they would otherwise be unable to access~~.

The investment policy required under LR 15.2.7R is the articulation of how the fund will manage its assets and spread its investment risk going forward. The mandatory requirements cover asset allocation, risk diversification and gearing, including maximum exposures. We will carefully examine these statements ~~–~~– in light of the intended asset class ~~–~~– to assess whether the proposed investment policy suggests there is a risk that genuine diversification may not be achieved.

LR 15 does not set arbitrary limits to individual exposures, but where the investment policy potentially allows an individual investment to represent a material proportion of the applicant's portfolio, we will seek to understand why the sponsor believes the proposed policy enables a genuine spread of investment risk. For example, if an applicant proposes an investment policy with limits suggesting in excess of 25% of the portfolio may be represented by a single asset, we would certainly expect to understand how the sponsor has reached its conclusions. Our view on the eligibility of an applicant with such an investment policy will vary depending on the specifics of each case.

Trading activity ~~– LR 15.2.3AR~~

A fund must not engage in trading activity that is significant in the context of the fund as a whole. This does not prevent the underlying investments from being trading businesses, but if the fund itself is actively engaging in activity which would more typically be seen in a company listed under LR 6 or LR 14, this is inconsistent with what is envisaged as a fund under the Listing Rules. As part of the eligibility review, we will

need to be satisfied that the applicant is not a commercial company that should be assessed against the eligibility criteria set out in LR 6 or LR 14.

In determining whether an applicant is credibly described as a closed-ended investment fund, we will take into account how the applicant is described in the eligibility submission from the sponsor, the information provided in the draft prospectus, conversations with the sponsor, and other open-source material. There is no definitive list of indicators. However, the sort of factors we will consider may include:

- the asset class – for example, we would spend less time considering a FTSE tracker ~~in comparison with~~than a wind farm fund;
- for assets that are majority owned and/or require more operational oversight than classic asset classes such as shares or bonds – how the operational aspects will be managed and by whom;
- how the applicant is presented and whether there is ~~there~~ a clear focus on spreading investment risk;
- the rationale for follow-on investments;
- how many (if any) staff are employed by the fund, and in what capacity;
- the track record of the individuals behind the proposal,; and
- the intended use of capital and debt facilities in the context of the specific asset class.

Each applicant will be considered on a case-by-case basis and we will assess the proposition as a whole. As such, factors that may be acceptable for a fund in one proposal may, in the context of a different asset class/strategy, render the applicant ineligible for listing under LR 15.

Financing arrangements ~~– LR 15.2.4AG~~

Allied to our consideration of both of the above elements is an examination of the fund's financing arrangements.

In the context of risk spreading, we will look at how the fund employs its debt facilities and whether certain financing structures undermine what is otherwise a diversified portfolio. Secured debt ~~which~~ that sits at issuer level or across multiple assets may imply that, in the event of default, material parts of the portfolio may be at risk, which is, prima facie, inconsistent with the concept of risk diversification. We accept that there can be legitimate reasons for debt being employed in this manner. However, as part of the eligibility process, we will challenge the sponsor to understand how it has satisfied

itself that the applicant can indeed spread investment risk in spite of the gearing structure, taking into account the proportion of the portfolio covered by any one arrangement.

However, there may be cases where the financing structures are such that they create a concentration of risk within the applicant's portfolio in such a way that we cannot look through to the individual assets ~~which~~ that are covered by the financing structure (e.g. a number of assets used to secure a specific loan). In such cases, we ~~would~~ may consider the assets on an aggregated basis (or the 'pool') as the investment, which is then subject to the fund's exposure limits and the overriding principle of spreading investment risk.

We do not typically treat secured pools found in real estate funds as creating a concentration of risk. Although this guidance is addressing all asset classes, we note this is a longstanding practice in real estate funds and we are not aware of investor concerns suggesting this poses risks that investors would not expect to encounter in such funds.

Further, as provided for in LR 15.2.4AG, there is no prohibition on a fund taking controlling stakes in investee companies. However, it is not consistent with the principle of spreading investment risk to plan to use one investment's operational cash flow to fund the day-to-day financing of another investment. We would also examine the rationale for the existence of ~~We would also not expect financing structures to include~~ certain facilities, such as overdraft arrangements, to ensure they are not suggestive of the applicant being run as a commercial company. We acknowledge that there are limited justified uses in the context of a fund, such as funding/bridging working capital requirements (which would not be expected to be significant), or for non-investment purposes, such as own share purchases, and we would engage with the sponsor to ensure we fully understand what is proposed.~~Such activity is suggestive of the applicant being run as a commercial company.~~

Ultimately, we would expect a fund to be able to make an investment decision in relation to each asset on its own merits~~, without needing to take into account whether it will be detrimental to other parts of their portfolio to exit or increase an investment~~.

UKLA Technical Note

Master-feeder structures

Ref: UKLA / TN / 409.1

LR 15.2.6R, LR 15.4.6R and LR 15.4.6AG

LR15 sets out specific requirements for master-feeder structures. LR 15.2.6R and LR 15.4.6R recognise that a feeder fund may achieve a spread of investment risk by ensuring:

- the investment policies of the underlying master fund are consistent with its own and provide for the spreading of investment risk; and
- the master fund acts in a way which is consistent with the feeder fund's investment policy and spreads investment risk~~.~~

The effect of these rules is to enable feeder funds to comply with the LR 15 rules on spread of risk by taking into account diversification at the level of the master fund.

As set out in LR 15.4.6AG, a feeder fund should have the ability to withdraw its funds if the master fund does not ~~in fact~~ spread investment risk, although we recognise that in practice this withdrawal may be after some delay~~, – –~~ for example, because the underlying investments held by the master fund are illiquid or subject to restrictions on their realisation.

The effect of the additional rules ~~which~~ that apply to feeder funds (LR 15.2.6R, LR 15.4.6R and LR 15.4.6AG) is to recognise that the board of the listed issuer will have less direct control over the underlying portfolio than it would if the funds were invested directly, as feeder funds are typically minority investors.

We have come across structures that differ from traditional master-feeder structures, either because the feeder fund also proposes to invest some funds directly (outside of the master fund), or because the feeder holds a majority percentage stake in the master fund that ~~should~~ allows it to exercise ~~some~~ control over the master fund ~~(at extremis 100%)~~.

~~Clearly in~~In such scenarios, the implicit recognition that the issuer could not influence the direct investments, or the investment choices of a majority~~–~~owned master

respectively, clearly does not hold. As such, the investment policy of the issuer should reflect the issuer's control of these investments by clearly describing how investments will be made by the issuer in a way ~~which~~ that is consistent with its objective of spreading risk, rather than just referring to the master's policy – as would normally be the case for a feeder fund.

When considering the eligibility of a new applicant feeder fund, we expect the sponsor to be able to demonstrate that there is a genuine master-feeder relationship, as distinct from a fund that holds investments through subsidiaries or other controlled special purpose vehicles. Where the applicant has the sole economic interest in the master fund, or controls the master fund, it calls into question whether the structure is in reality a master-feeder.

In addition, a feeder fund ~~which~~ that proposes ~~also~~ to make direct investments will need to consider whether it continues to meet the criteria for a feeder fund, given that LR 15.2.6R and LR 15.4.6R apply~~applies~~ only where an issuer invests principally in a master fund.

UKLA Technical Note

Definition of 'investment manager'

Ref: UKLA / TN / 410.1

LR 11, LR 15, and Glossary, LR Appendix 1

The Listing Rules use a very broad definition of investment manager. This definition was drafted in recognition of the fact that funds from a variety of jurisdictions are listed under LR 15, and that their investment managers may be structured in a variety of ways, making a cross-reference to a specific regulated activity impractical.

In the context of the AIFMD, where there is an external AIFM and portfolio management is delegated to a separate entity, we have been asked to clarify who we consider to be the investment manager. Our presumption would be that both entities fall within the definition of 'investment manager' for the purposes of the Listing Rules and, as such, both would be related parties of the listed entity for the purposes of LR 11. We believe this is consistent with the view the industry has taken.