13 Private equity

Note: This sectoral guidance is incomplete on its own. It must be read in conjunction with the main guidance set out in Part I of the Guidance.

Overview of the sector

13.1 The ML Regulations define who is covered by those regulations by close reference to the Third Money Laundering Directive ("the Directive"). Private equity firms in the UK are generally authorised and regulated by the FSA and are considered to be covered by the Directive and ML Regulations because they will carry on one or more of the Banking Coordination Directive activities listed in Schedule 1 to the ML Regulations. Such firms may also be covered by the Directive and the ML Regulations because, in practice, they perform the functions of a collective investment scheme when marketing its units or shares. Private equity firms are therefore "financial institutions" within the meaning of the Directive and the ML Regulations, and reliance may be placed on them under the ML Regulations by other private equity firms and others subject to the Directive, such as banks, lawyers, accountants, etc.

13.2 Private equity business (for the purposes of this guidance) means activities relating to:

- The marketing, raising and acceptance of moneys into private equity funds (usually from institutional investors);
- The investing of these funds by providing long term finance to a range of businesses, from early stage to large established companies. Usually the investee companies are unquoted but transactions include quoted companies from time to time (for example, public to private transactions);
- The management of these investments (often involving active board participation) and exercise of negotiated equity holder rights; and
- The subsequent realisation of the investment.

13.3 Investors in private equity funds tend to have long established relationships with the private equity firm, normally resulting in a very well known investor base. Prior to making any investment in a business, the private equity firm will conduct extensive due diligence on the business and its owners, identifying areas of risk, including money laundering considerations.

13.4 Once invested, ongoing monitoring of the investment through active board participation and regular involvement allows the firm to assess whether the investee's activities are consistent with the financial performance of the company, and also enables the firm to observe the conduct of the key managers of the business at first hand. In connection with investee companies, this will satisfy a firm's obligation to conduct ongoing monitoring of the business relationship under the ML Regulations.

13.5 There will always be an obligation for a firm to carry out such investigative work as it feels necessary where any circumstances exist which may lead it to suspect money laundering or terrorist financing is a risk, and the following guidance should be read in that context.

13.6 For AML/CTF purposes, in a private equity context there are two distinct groups:

- Investors in fund vehicles operated, managed or administered by private equity firms – paragraphs 13.7-13.27 (investors)
- Persons involved with the private equity firm ("counterparties") when investing and divesting (e.g. investee companies when investing and purchasers on exit) – paragraphs 13.28-13.50 (transactions)

Persons falling into the categories identified above may be classified by a private equity firm as its "venture capital contacts" for the purposes of other aspects of FSA regulation, as opposed to being classified as the firm's regulatory clients.

Investors

(i) Product risk

13.7 Investors typically invest in a fund as limited partners in a limited partnership. The limited partnership will usually be collectively managed or advised by the private equity firm. Investors invest for the long term and the timing of any return of capital is unpredictable. This form of investment is very illiquid, with no ready market. Transfers of interest in the partnerships can take place, but only after strict due diligence (and in some funds only after a minimum initial investment period) and usually only with the specific approval of the General Partner or Manager. Payments/repayments would also only tend to be made to the investor itself (any payment to a third party would usually only be made with the express consent of the General Partner and/or Manager of the fund).

13.8 This type of product would normally be considered to be a lower risk.

(ii) Customer risk

General

13.9 Investors in a fund are mostly institutional, such as insurance companies, pension funds of large corporates or state organisations (including Sovereign Wealth Funds), other financial services companies, charitable organisations and some funds of funds. There may also be a small number of high net worth individuals.

13.10 The acceptance of investors into a fund is a relatively long process with significant levels of due diligence performed by the firm and the prospective investor(s). Key representatives of the investors will often meet face to face with senior executives of the firm.

13.11 The relationship between the firm and investor is such that a high proportion of investors will often commit over a number of years to consecutive funds of the firm; thus the relationship continues over a long period and the source of funding remains relatively constant.

13.12 For the reasons set out in paragraphs 13.9 to 13.11 these investors would generally be considered to be low risk, although high net worth individuals may require extra consideration in any risk evaluation.

13.13 Firms seeking to raise funds for the first time, or from a significantly larger investor base, may be considering accepting funds from potentially higher risk investors, and the extent of the due diligence should be adapted accordingly.

Timing

13.14 Identification checks in respect of investors in a fund should be completed and the firm satisfied as to the source of funds before the contractual commitment to accept the investor into the fund is made. Where there is any assignment of an interest in a fund, any identification checks should be completed before the assignment is approved and executed.

Identification

13.15 In relation to each investor a private equity firm should obtain at least the standard evidence for that type of investor in accordance with Part 1, chapter 5. In most cases (see paragraph 13.16, for example), the key piece of standard evidence will be to identify whether there is any natural person beneficial owner holding an interest of 25% or more and (where there is) to take risk-based and adequate measures to verify the individual's identity (see paragraphs 13.18 to 13.27 below).

13.16 In the case of institutional investors, it may be appropriate to conduct only simplified due diligence (see Part 1, section 5.4) because the investor will itself be regulated.

13.17 Where a corporate investor is not well-known to the private equity firm and is quoted on a regulated market or exchange which is not located in the UK, the EU or in an equivalent jurisdiction, it may not be practical for the firm to obtain reliable evidence as to the quality of the regulation in that market or exchange. In addition to the standard identification requirements set out in Part I, paragraphs 5.3.138 to 5.3.141, the firm should seek to establish, where possible, who the corporate investor's external accountants, lawyers and brokers are, and their reputation in the market, before making a decision on what, if any, further verification of identity is required. Similar considerations should be made when it appears necessary to go beyond the standard evidence of identity.

Identifying the Beneficial Owner

13.18 Where the investor is a natural person or a wholly-owned investment vehicle of a natural person, it will be straightforward to identify the beneficial owner.

13.19 Where the investor is a "family office", the money will usually be provided by one or more trusts. The firm should look through the investment structure to identify the relevant trusts, and verify the trusts' identities in accordance with Part 1, paragraphs 5.3.246 – 5.3.269. A private equity firm may have to take a decision as to whether it can rely on a representation from the administrator of the family office (or equivalent) concerning the beneficial owners, or in appropriate cases confirmation from reputable professional services firms.

13.20 Where the investor is a pension fund or endowment, the firm must first understand the structure of the pension fund or endowment in order to determine its approach to identification. The firm should identify both the source of the funding, for example the sponsoring employer, and the person who controls the investment decision, for example the trustee or an investment committee, although the exercise of investment discretion may have been delegated to a regulated firm acting as agent. In identifying the beneficial owner, there will either be identified beneficiaries, in which case it is unlikely that any one individual will have an entitlement to 25% of the property (and a representation from the trustee to this effect should be sufficient).

Identifying the Beneficial Owner – Funds of Funds

13.21 It may be more complicated to identify a beneficial owner where the investor is itself a fund vehicle, including a private equity fund of funds.

13.22 The requirement to identify the beneficial owner and to understand the ownership and control structure in accordance with the ML Regulations would normally be confined to (a) the fund of funds general manager or partner (as the true "controller" of the fund of funds) (hereafter, the "manager") and (b) the fund of funds itself. The assessment should not normally need to go beyond that level of the structure. In particular, it should not normally be necessary to keep looking "up" the structure until one or more natural persons is identified.

13.23 Where the manager is regulated and subject to supervision in the UK, the EU or an equivalent jurisdiction, no further identification work would normally be required because the regulated Manager will usually deal as agent on behalf of the fund of funds.

13.24 Where the manager is not from an equivalent jurisdiction, even though it may be regulated, or where the manager is unregulated but operates in an equivalent jurisdiction (as is often the case in the US private equity industry, for example) the firm needs to exercise its judgement as to the likely risk presented by investors in the fund. Factors to take into consideration include:

- the profile of the Manager in the market place;
- its track record in the private equity industry; and
- its willingness to explain its identification procedures and provide confirmation that all underlying investors in the fund have been identified and are known to the manager.

13.25 There will often be legitimate confidentiality concerns on the part of the manager in respect of the beneficial owners of the fund. However, funds of funds are often widely held and it is unlikely that there will in fact be any investor which is a beneficial owner with an interest of more than 25%. Subject to the considerations in 13.24 in order to establish this, a private equity firm is entitled to rely on a representation from the manager (whether or not regulated or supervised) that, to its actual knowledge, there is no natural person beneficial owner of more than 25% of the shares, limited partnership interests or voting rights (as appropriate) in the fund of funds. Where such a natural person beneficial owner is encountered, the private equity firm must identify them and take risk-based measures to verify their identity.

13.26 In addition, the private equity firm should obtain the other items of standard evidence in relation to the manager and the fund of funds vehicle. Depending on the results of the risk evaluation, it may be appropriate to obtain documents (for example basic constitutional documents), or a combination of documents and representations, from the manager.

13.27 Possible examples of the sort of representations referred to in paragraphs 13.25 are set out below. These representations do not represent evidence of identity in the way that the pro forma confirmations in Part 1, Annex 5 do, but they should be used as part of the firm's risk-based approach and adapted accordingly.

Example of representation provided by a fund of funds manager or general partner of a fund of funds

"We [NAME] [regulated by [NAME OF REGULATOR AND FIRM REFERENCE NUMBER IF APPROPRIATE]] hereby certify the following in respect of [state name of fund(s) vehicles e.g. limited partnership(s)] (the "Funds"), for whom we act as agent.

1. [In accordance with the laws of our jurisdiction, and the procedures under which we operate, designed to combat money laundering] [we confirm that]:
    - we have identified the underlying beneficial investors in respect of the Funds and carried out customer due diligence on all of the investors in the Funds;
    - we confirm that to our actual knowledge [(having made [reasonable] enquiries)]] there are no undisclosed or anonymous principals; and
    - we are not aware of any activities on the part of those investors which lead us to suspect that the investor is or has been involved in money laundering or other criminal conduct.

2. Should we become suspicious of any such activity then, subject to any legal constraints, we shall inform [you/the relevant regulatory authorities] promptly.

3. To our actual knowledge [(having made reasonable enquiries)] there is no natural person who is the beneficial owner of more than 25% of the [shares/limited partnership interests/ voting rights] in any of the Funds.

4. We will retain, until further notice, all documentation required to identify the underlying beneficial investors in the Funds [and which we have obtained for the purposes of our due diligence]. [We will provide such documentation [to you]to your Compliance Officer][direct to any regulatory authority] [on request][where you are required to disclose it to such regulatory authority]]."

Transactions

(i) Product risk

13.28 The product is the provision of funds by the firm in a number of different structures predominantly to unquoted companies. The funding is usually provided for the long term, after the company and its management have been subject to detailed due diligence and review. The firm has an ongoing obligation to monitor its investee companies and their management teams, often involving representation on the board of the company and receipt of regular financial and operational information.

13.29 The shareholding is highly visible and any failings on the part of the company would be closely aligned to the reputation of the private equity firm.

13.30 If all these factors are present it is considered unlikely the provision of funding will be used for illegal purposes and that therefore the product will be a lower risk. The absence of one of these factors, such as the non availability of detailed due diligence work or the reliance on a third party, may require the firm to obtain more detailed verification to satisfy itself that the funds are being provided for legitimate purposes.

(ii) Customer risk

13.31 There are a number of parties involved in a private equity transaction, and the level of identification required in respect of each will vary.

Investee company (Company into which funds are being paid) and its directors

13.32 All directors should be identified and the identity of key directors should be verified in accordance with Part I, paragraph 5.3.155.

13.33 This company will either have been the subject of extensive due diligence, or will be an “off the shelf” vehicle, especially established by the firm for the purpose of acquiring the investee company. Where the firm or the fund it manages, is acquiring securities in the investee company direct from a shareholder, the guidance in paragraphs 13.49 and 13.50 is relevant.

13.34 The jurisdiction of the vehicle may cause the risk profile of the investee company to increase, but provided that the company has been properly established and that the reason for the selection of jurisdiction is understood and appropriate, there should be no need to obtain additional verification.

13.35 Whilst the legal obligation relates to identifying the investee company into which funds are being paid, where that vehicle is itself undertaking a linked transaction there must be a clear understanding of the ultimate recipient of the funds and the flow of financing, particularly with the increasing complexity of deal structures.

Relevant Co-investor

13.36 Where the firm acts as lead investor in the round of financing where it has arranged co-investors’ involvement in the deal, and where the co-investors are relying on the firm, it must identify the co-investors.

13.37 Following the firm’s assessment of the overall risk presented by those co-investors, it may decide to verify their identity and the underlying source of their funds.

13.38 The identification requirements exist not only at the initial investment stage but also at any follow-on financing, to the extent that any new relevant co-investors are taking part. The firm should understand the business of a new co-investor and the reasons for it wanting to invest, particularly when the target of the financing is not performing well.

Timing

13.39 Customer due diligence checks should usually be completed when it is reasonably certain that the deal will complete, and in all cases before completion of the investment. Where there are subsequent changes to the board of directors, consideration should be given to the need to verify the identity of the new directors, particularly if they are co-investing, in light of the guidance in paragraph 13.32.

Purchaser on exit

13.40 The realisation of a private equity transaction will typically be made either by means of a listing, sale to a trade buyer, sale to existing management or a 'secondary sale' to another private equity fund. If the sale is to a member of existing management who has been known to the private equity firm in the context of the investment concerned (or of another investment), the firm should consider the relevance of any verification given its existing relationship with, and knowledge about, the management.

13.41 The pressures of achieving a successful exit may heighten the risk of limiting the amount of due diligence performed on any potential purchaser on exit. In these circumstances the firm needs to ensure that its controls for proper verification of identity and source of funding remain robust. Where the purchaser is a private equity fund, consideration should be given to a risk based approach of the kind described in relation to fund of fund investors into a private equity fund (see 13.21 to 13.27 above). This will often be appropriate.

Timing

13.42 Identification checks should usually be completed on purchasers of an existing investment as soon as practicable when a deal looks reasonably likely to proceed and in all cases before completion of the sale.

(iii) Market risk

13.43 The range of companies invested in is determined by the stated parameters of the fund as agreed with the investors and the level of regulation and standard of controls in which each operates will vary enormously. The strength of the firm's due diligence process serves to identify where any risk exists within the investee companies and the firm should develop its AML/CTF approach accordingly.

13.44 Providing funding to a company which operates across a number of unregulated territories, even if the parent is incorporated or registered in a well-regulated territory, may present a higher risk than an equivalent business which operates out of one well-regulated territory, and appropriate levels of verification should be considered.

13.45 An assessment may be required as to whether the type of business being invested in is likely to be a target for money launderers, and the approach to due diligence adapted accordingly. Businesses which involve high volumes of cash or near cash transactions, for example, casinos, hotels, are likely to be at greater risk than, for example, an early stage biotech company.

(iv) Other issues

Representations issued by private equity firms to third parties

13.46 In respect of their Funds, firms should be prepared to confirm whether in their actual knowledge there is any natural person who is the beneficial owners with an interest exceeding 25% of that fund. When disclosing information about investors in accordance with relevant confidentiality provisions, firms should consider agreeing to disclose the information to a certain department within the third party, such as the Compliance Officer only.

Use of verification carried out by others

13.47 Private equity firms make extensive use of professional advisers, especially where the required knowledge does not exist in the firm itself. The investee companies themselves and any co-investors will usually appoint professional advisers to ensure that their own interests are represented in any negotiation. In some cases, these advisers are themselves under an obligation under the ML Regulations, or under similar legislation in the EU or in an equivalent jurisdiction, to verify the identity of their clients. Depending on the circumstances, and the firm's knowledge of/relationship with the investee company, the firm may consider it appropriate to take account of information or written assurances provided to the firm by these third parties, as part of the overall risk-based approach.

13.48 The requirement to appear before a notary in certain jurisdictions when signing documents such as the sales and purchase agreement , shareholder's agreement etc, can provide adequate verification. However the notary's certificate should only be considered as adequate if it states the full names and identity card numbers (or equivalent) of the individuals appearing before the notary, plus details of the evidence provided for their authority to act as representatives of the parties involved.

Vendor (Beneficiary of funding decision)

13.49 The decision to invest by the private equity firm will usually result in one or more individuals benefiting financially. In some instances these individuals will continue to be shareholders in the company, with the benefit being represented by the potential of significant future gains. In other cases, the beneficiary(ies) may be the original founders of the business who no longer participate.

13.50 The private equity firm will not wish to damage its reputation by becoming associated with inappropriate individuals. Whilst vendors of an investee company are not customers of the firm under the ML Regulations unless they are selling securities in the investee company directly to the firm or to its fund(s), the firm should be aware of who the vendors are. The nature of the due diligence work performed is such that the origins of the business and the individuals involved will have been the subject of extensive review and investigation. The private equity firm should ensure that it has sufficient information about the vendors (this may or may not require obtaining verification of identity) so as to be able to demonstrate that the firm had no knowledge or reasonable grounds for suspicion of money laundering on the part of any vendors in relation to the transaction.