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Buying or selling an FSA regulated business?

More than 1,000 FSA-authorised financial services businesses potentially changed hands in the last year, or to be more precise 516 in the six-month period to September 30, 2010 and a further 563 in the six-month period to March 31, 2010.

This was according to service standard figures published by the Financial Services Authority on the number of notifications which had been made to the FSA for a decision regarding a proposed change of control which were then processed by the FSA. Previous figures going back to 2008/2009 showed similar levels of activity, albeit down from the high point of the six months to March 31, 2008, when the FSA processed 951 such notifications. This had been in marked contrast to other sectors and the regulated UK financial services sector is comparatively buoyant with acquisition activity.

It is possible to speculate on what is driving this activity. Regulatory change will contribute to some business owners' decisions to sell and leave the financial services market and, looking forward, the implementation of the Retail Distribution Review in the investment sector may well be a catalyst for existing as well as future sales of IFA businesses. On the buyer's side there will be firms seeking to increase market share in their existing markets and then perhaps those firms seeking to acquire a company with a valuable permission that is required to carry out what, for the acquirer, will be a new regulated activity. Some have speculated that the reported increase in the time it is taking the FSA to approve new permissions has in itself been a driver for this market activity, with businesses seeking a faster route to market through the acquisition of companies with existing permissions rather than themselves applying to the FSA for permissions.

Having found the business to buy, and agreed the premium to be paid, what are some of the processes to be undergone and the challenges to be faced? Legal documentation will need to be prepared and negotiated, including a share purchase agreement under which, among other things, the seller will be asked to give warranties about the business. While these include regulatory compliance, a buyer should also undertake the necessary amount of due diligence, rather than just relying on warranties. This due diligence should work with, and not against, any warranties given by the seller. The buyer should do all it can to offset any risks which might be attached to the business to be acquired, rather than simply accepting documentation presented as being in "standard form". After all, in a worst case scenario the business could turn out to have a negative value, particularly if pre-acquisition breaches of FSA regulation lead to post-acquisition FSA enforcement. This is especially important if there are disputes about whether these matters are covered by warranties or whether the buyer's due diligence ought to have revealed the pre-acquisition breaches.

The process of obtaining FSA approval for a change of control also needs to be given attention both by seller and buyer. In broad terms, FSA approval must be obtained by any person who intends to act alone or in concert with others to acquire direct or indirect control of any FSA-authorised company, or even to acquire a minority stake in that company. Various thresholds have been set to determine whether a notification needs to be made to the FSA for a decision, and before a shareholding in a regulated business is acquired, careful consideration is necessary. The FSA must carry out its assessment within a set time period of 60 working days. The FSA may, however, stop the clock within the first 50 working days by calling for an "interruption period" to request further information. The 60-day period may only be interrupted once and this may last no longer than 20 working days. Once FSA approval is given, the parties then have a limited period of time to complete the acquisition. If the FSA decides to oppose an acquisition or imposes restrictions, then the acquisition must proceed in accordance with the restrictions or not at all. In particular the FSA has the power to apply to the court for an order of sale in relation to any shares acquired in breach of a decision. Proceeding with an acquisition in defiance of the FSA is an offence carrying a sentence of up to two years in prison and an unlimited fine. Appeals against a refusal by the FSA to approve a change of control can be made to the Regulatory Transaction Committee, the internal committee that oversees when and how the FSA exercises its statutory powers.

The seller is likely to have to wait for the payment of some element of the purchase price depending on future performance of the business, and this is particularly so in the financial services sector given the nature of many authorised businesses. This is done under a mechanism set out in the share purchase agreement known as deferred consideration. In these circumstances the seller is put in a position of being the creditor of the business it formerly owned. The seller therefore needs to carry out an assessment of the buyer's credit risk for payment of the balance of the purchase price, just as the buyer needs to carry out a credit risk assessment of the seller in relation to warranties given as to the state of the business being acquired. In addition, the buyer's bank will typically require security over the assets of the business being acquired, whether or not they have themselves provided funding for the acquisition, and also often the seller, as a creditor of the business, will enter into an intercreditor agreement with the buyer's bank. The function of this agreement is to subordinate the seller as a junior creditor to the bank but the terms do need to be read and understood, not least as they often contain positive obligations on the seller to be owed to the buyer's bank.

This article was first published on *Complinet*, a market-leading daily, web-based news service for compliance professionals in the financial services sector.

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