Ashurst

Funds Insider

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Outpacing change

contents

Foreword

Welcome to the latest edition of Funds Insider, our quarterly publication focusing on current topics of interest for our private capital clients.

We are pleased to include a diverse selection of articles in this quarter's edition.

M&A trends feature heavily, with two sectors that have kept our teams across Europe busy over the last year coming into focus: asset management and technology. Following a similar theme, we take a closer look at the ever-increasing complexity of regulatory clearances in an M&A context, as well as the UK Government's 'Make Work Pay' plan, and an update on the latest FCA review of valuation processes for private market assets.

Last but not least, we focus on the Middle East, an exciting and dynamic hot spot for private capital activity where Ashurst itself has directed significant strategic growth investment in the last couple of years and provide an overview of Shari'ah compliant investment structures.

We hope you enjoy reading this edition of Funds Insider and please do get in touch if you have any feedback or if there are any topics that you would like us to cover in future editions.

Funds Insider
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M&A activity in the asset management industry

By Rob Aird, Gavin Weir, Markjan van Schaardenburgh, Dallan Pitman and Jacob Gold

Fuelled by investors' appetite for exposure to new asset classes, whether partnering with third parties to expand distribution or simply to build scale, there has been significant M&A activity in the asset management industry over the last 12 months. This is a trend which Ashurst expects to continue over at least the short to medium term.

We have seen a discernible increase in asset management M&A activity across Europe in the last 12 months. Whether that's investors looking for more diverse investment strategies from their investment managers, institutional managers seeking to gain exposure to alternative strategies, macro-economic dislocation, or perhaps it's simply the right moment to capitalise on an already buoyant market in the sector.

But despite the strong rationale for doing an asset management deal, executing these transactions is a delicate and complex exercise. Promising deals can flounder if parties fail to keep a firm grip on the detail.

We outline six principles deal parties should focus on to ensure that asset management transactions succeed.

1 Retain and incentivise talent

Asset managers are in effect people-focused, cash-distributing businesses. Neglecting talent retention is a recipe for transaction failure.

Communicating with key team members early in the process is essential. They need to feel they are part of the process and involved in the long-term strategy of the firm.

Sharing the monetary benefits of the transaction with the core team is also critical, and deal structures must include some form of retention and incentivisation package to lock in talent. This could be in the form of equity rights, deferred compensation schemes or special bonus pools.

Firm structures and incentive packages will vary significantly from deal to deal, so a bespoke approach is required. In all situations, it's important to keep everyone rowing in the same direction and financially motivated. This is often the key to avoiding client attrition.

2 Avoid client attrition

Deals often see an investment in the management company bundled with capital allocations to a firm's funds. This can raise potential conflicts of interest because other fund investors, without a stake in the management company, may feel that they are not privy to the same levels of information about fund strategy and performance.

Existing investors could also be concerned about what a deal means for team stability, investment strategy, and, ultimately, long-term fund performance. Significant investors may also have rights to redeem their investment(s) and terminate their commitments on a change of control.

Again, effective communication is crucial to address client concerns. Leaving communication too late in the process, and presenting the wrong story to investors, can lead to rapid client attrition, though this has to be balanced against the risk of releasing deal details too early in the sales process (and potentially prejudicing the regulatory change of control issues described below).

Robust "ethical walls" and conflicts policies should be baked into deal documents to assure existing investors that any new investor will not prematurely gain access to inside information. Be in a position to articulate how the combined business will not result in the upending of successful investment strategies and workflows.

3

Understand and address regulatory complexity

In almost all asset management deals, a change of control will require clearance from the relevant regulator(s) – this could entail complex filings for antitrust, financial regulatory and/or foreign direct investment (particularly where the target's portfolio includes investment(s) in restricted sectors such as defence, utilities, certain media, financial services). These change of control requirements can be triggered by sales of equity stakes as low as 10%, depending on the jurisdiction, and may necessitate a full global survey.

For fund managers, which typically have offices in a number of jurisdictions, change of control clearance is especially complex as the regulator in each jurisdiction will have to sign off. Clearance processes, requirements and timelines also vary from country to country.

Generally speaking, the level of regulatory scrutiny and sophistication has increased, with watchdogs seeking evidence of how a combined entity plans to deal with compliance and manage conflicts of interest.

An added layer of complexity comes into the frame when making these disclosures to regulators involves sharing sensitive commercial information. A buyer that has had a difficult but low-profile engagement with a regulator in one jurisdiction, for example, will usually be obliged to disclose this to regulators in other jurisdictions when change of control thresholds are triggered.

Failure to grasp the disclosures required for change of control clearance, as well as the time and resources required to make the relevant filings and obtain the applicable clearances, can scupper otherwise compelling deals.

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Move fast... but not too fast

The time required to close a deal will be dictated by the length of the regulatory clearance process, which can take several months.

It is important to do as much work as possible before submission for clearance to ensure that there are no lingering uncertainties that could disrupt a transaction while it is being reviewed by the regulators.

Planning the execution so that relevant details can be disclosed to investors as soon as parties exchange contracts goes a long way to limiting the chances of a deal derailment.

When the target needs investor approval as part of the deal process, the timing is even more delicate, and has to be managed to keep investors apprised of the deal without slipping into a full-weight negotiation to secure their support.

5

Equity rights and governance

The bigger the investment in a manager, the more involved the investor will want to be in the management company.

This not only raises the conflict of interest point mentioned above, but also means the rights and involvement of the new investor will need to be clarified.

What investors do not want to see is a manager who should be focused on running the business being bogged down with compliance and reporting requests from a minority shareholder in the firm. Complications can also emerge as numbers of major shareholders proliferate.

Clarity on what each party's equity and governance rights are post-deal, and how these could evolve in the future, is a must.

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Is a deal a one-off or the first of many?

If a deal is a one-off, equity and governance rights can be established up front and are unlikely to change much. But if a deal is the first of many, and equity could be used as part of the consideration for potential future acquisitions, equity splits can move materially.

This has wide implications for a firm, particularly in the area of talent retention as key people can decide to walk if equity holdings or long-term incentives are unexpectedly diluted.

Negotiating how equity and governance rights will shift in advance of future deals is difficult, but if you do the deal first and put worrying about future deals and their impact on equity and governance rights on the back burner it can lead to bigger problems down the line.

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The UK Government's 'Make Work Pay' plan: What funds need to know in all instances

By Crowley Woodford and James Furber

Sweeping reforms to UK employment law are on the horizon as the Government begins to implement its "Make Work Pay" plan. This article breaks down the major changes that funds should be aware of, including enhanced protections in the Employment Rights Bill, tougher measures to prevent sexual harassment, the proposed adjustments to employee status, and the extension of pay gap reporting to those with disabilities and to ethnic minorities.

1 The Employment Rights Bill

The Government's proposed Employment Rights Bill (the Bill), introduced to Parliament in October 2024, represents the most substantial shift in UK employment rights since Margaret Thatcher. It is expected that most of these changes will not come into effect until Autumn 2026. The Bill is subject to further amendments and this article outlines the key provisions of the Bill that businesses need to be aware of as of the March 2025 amendments.

Unfair dismissal

The Bill will abolish the two-year qualifying period and give employees the right to claim unfair dismissal from day one of their employment. Employers will have some leeway to assess new hires during a new statutory probation period during which employers will be able to follow a more straightforward process to dismiss employees for fair reasons including poor performance or misconduct (but a such "light touch" process will not be available to employers where the dismissal is because of redundancy). It is currently proposed that this probationary period will be nine months but this is subject to consultation.

Even though it is suggested by the Government that the procedure for employers during this probationary period will be "light touch" there are already indications that it will have many of the features of a full procedure such as a meeting with the employee and a written decision. It will therefore be important for employers to proactively identify, manage and resolve issues during the probation period to minimise the risk of any claims.

Flexible working

The Bill makes flexible working more accessible and difficult for employers to refuse. Building on reforms that came into force in 2024, employers will have to show that they have a specified and reasonable ground for rejecting a request. Employees will be able to challenge the rejection if the employer fails to act in accordance with the legal requirements so employers will need to review their policies and procedures to prepare for a possible increase in requests and claims.

Parental leave rights

The Bill proposes that various forms of family leave will be available to employees from day one of their employment. This includes paid paternity leave, unpaid parental leave and bereavement leave. Additionally, employees will now be able to choose to take their paternity leave before or after shared parental leave.

Fire and rehire

The Bill aims to curb the controversial practice of fire and rehire, where employers terminate and re-offer contracts with less favourable terms to employees who resist changes to their working conditions. Such dismissals will be automatically unfair unless the employer can prove that they faced financial difficulties and that the changes were unavoidable and necessary to save the business or prevent redundancies. This exception is incredibly narrow and therefore it is unlikely that many employers will be able to rely on this in practice.

Redundancy changes

The Bill will also broaden the application of the rules on collective consultation and notification of redundancies, by making them apply to any dismissal of (i) 20 or more employees within a 90-day period at a single establishment or (ii) where a different threshold is met. This alternative threshold was introduced through an amendment and has not yet been confirmed by the Government. It is understood that this threshold will be slightly higher and will capture redundancies made across the entirety of an employer's UK establishments. Currently, the rules only apply to a dismissal of 20 or more employees within a 90-day period at a single establishment.

Once this reform is enacted, employers should exercise increased diligence in tracking proposed redundancy figures across each employing entity to ensure they do not trigger collective consultation requirements.

2 Preventing sexual harassment

In October, the Equality Rights Act was amended so that employers will now have a preventative duty to take reasonable steps to prevent sexual harassment of their employees. If employers are found not to have complied with this new duty, they could face a 25% uplift in a penalty in the event of any successful harassment claims.

"Reasonable steps"

What constitutes "reasonable steps" varies by employer and is assessed objectively. Key factors include the employer's size and resources, the industry they operate in, and the nature of interactions with third parties. Guidance indicates that without a risk assessment, employers are unlikely to be fulfilling the preventative duty. Further steps that employers should be taking are outlined in the Equality and Human Rights Commission's (EHRC) 8-step guide for employers.

It should also be noted that the Employment Rights Bill will extend this duty to all reasonable steps, making the duty more onerous on employers.

Third party harassment

The current EHRC guidance states that the new preventative duty includes taking reasonable steps to prevent third-party sexual harassment towards employees. This could include when employees interact with customers, suppliers, or attend external events.

Currently this only forms part of the EHRC's guidance but the Bill will extend the preventative duty legally to cover third-party sexual harassment.

3 Further changes envisaged

Alongside the Bill, the Government published a policy paper outlining other measures to implement their plan to "Make Work Pay". This includes reform to employee status and a new bill that will extend pay gap reporting to cover ethnic minorities and those with disabilities.

Currently, there are three employment statuses: employees, workers, and self-employed. The Government plans to create a single status of 'worker' for anyone not genuinely self-employed, combining employees and workers into one category. This would entitle all workers to employment rights, including protection against unfair dismissal and would affect an estimated one million workers in the UK. The Government plan to consult on how to implement these measures in the upcoming "Single Worker Status Consultation".

The new Equality (Race and Disability) Bill has not yet been published by the Government. However, the Government has announced that this bill will extend the current pay gap reporting duty to mandate employers with more than 250 staff to report the pay gap between (a) staff who belong to an ethnic minority group and staff who do not and (b) staff who have a disability and staff who do not. It is understood that the Government will begin consulting on this legislation in due course.

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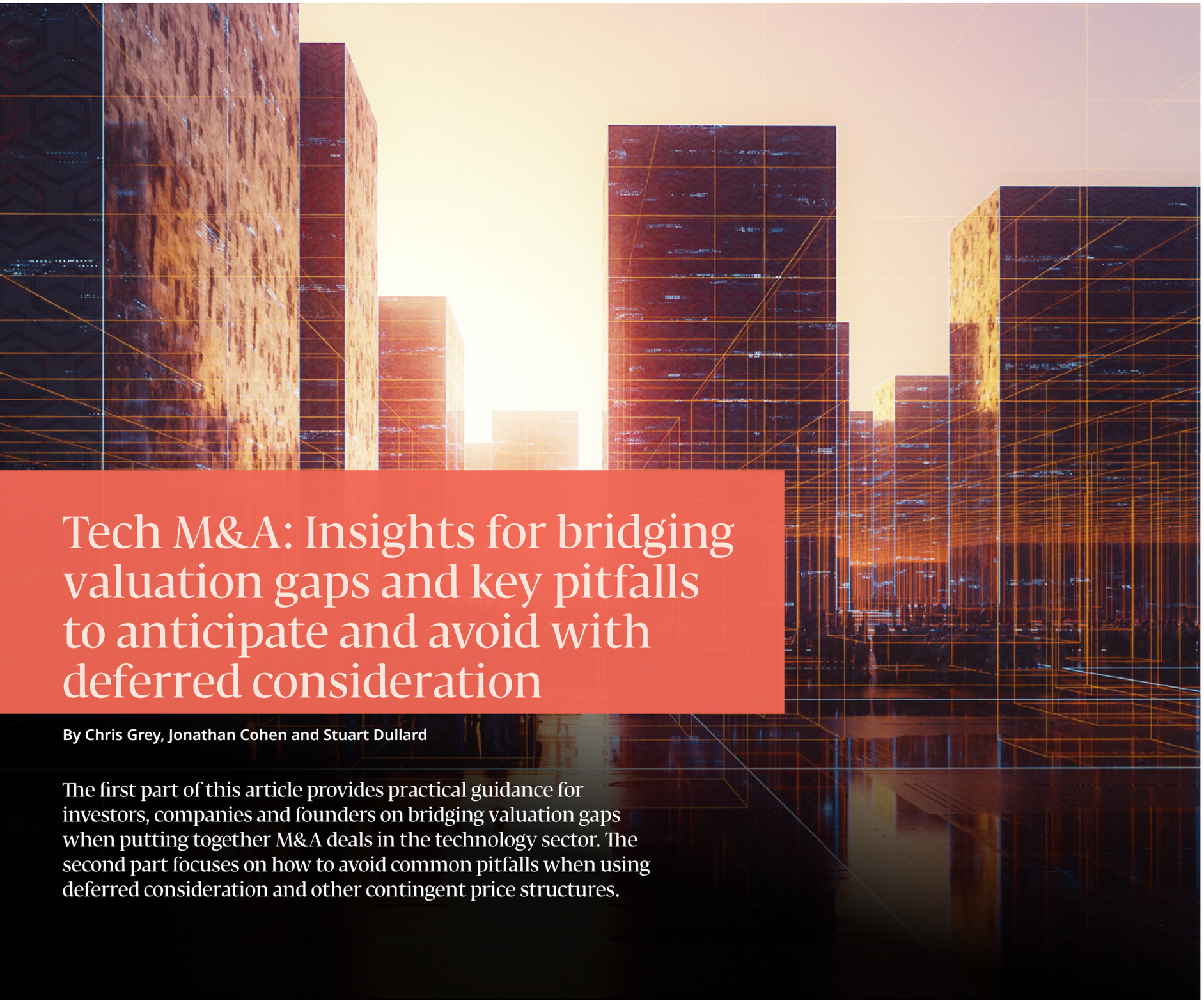


Tech M&A: Insights for bridging valuation gaps and key pitfalls to anticipate and avoid with deferred consideration

By Chris Grey, Jonathan Cohen and Stuart Dullard

The first part of this article provides practical guidance for investors, companies and founders on bridging valuation gaps when putting together M&A deals in the technology sector. The second part focuses on how to avoid common pitfalls when using deferred consideration and other contingent price structures.

Deal-making in the technology sector

Technology M&A activity in 2024 has continued to see strong growth led by both the demand for transformative technologies like AI and the return of private equity to the playing field. There is a substantial backlog of portfolio assets for sale and a new appetite from buyers and sellers to reach agreement on revised valuations for assets.

Tech sector growth has been a steady long-term trend, even disregarding the valuations during the exceptionally low interest rates of 2020-2022. LPs have been stepping up pressure on their fund managers to return cash (with DPI, or distributions to paid-in capital, becoming the word of the year for many PE and VC funds), even as a prerequisite to follow-on funding of new funds. Public markets are continuing to show record valuations for large global tech groups.

Bridging valuation gaps

What challenges do we anticipate for the year ahead? Technology companies can be particularly difficult to value given that they operate in markets defined by innovation and disruption and their value often relies on projected growth. These businesses also rely on intangible assets like software and other IP.

One challenge is helping buyers and sellers find common ground on prices in a fast-moving market. In other words: bridging a valuation gap. Much of this gap can be bridged with thorough diligence on a target's financial situation, its IP portfolio, its legal and regulatory risks. But often what's required is lateral thinking and deal-making solutions. Fortunately, there are several structures available in the Tech M&A toolkit that can be deployed to help bridge valuation gaps where there are differing views or contingencies, by sharing risks and aligning interests between the parties to reach a deal.

Practical solutions to achieve common ground

Rollover / Reinvestment

When a seller wants to take some money off the table without a 100% disposal, it may decide to structure a transaction to include a rollover or reinvestment of sale proceeds by the seller into the post-closing equity of the target, often through a new vehicle. Reinvesting is a means for the seller to "put its money where its mouth is" and creates strong economic alignment between the seller and buyer, who both share in the upside of the post-closing business, while also giving the seller (whether a

financial investor or a tech founder) the ability to cash out part of its stake. For some Private Equity funds, this may be required in order to implement the transaction. This mechanism achieves similar alignment between the parties as is found in a revenue-sharing or earn-out structure (see below); however, the buyer retains significant control over the target company after completion. A rollover can be relatively complex compared with an earn-out as it usually requires negotiation of a shareholders agreement and may include call and put options to facilitate an exit. Care is needed in structuring these transactions, especially with regard to taxation, the impact on any "drag and tag" sale process and the governance for the period following completion.

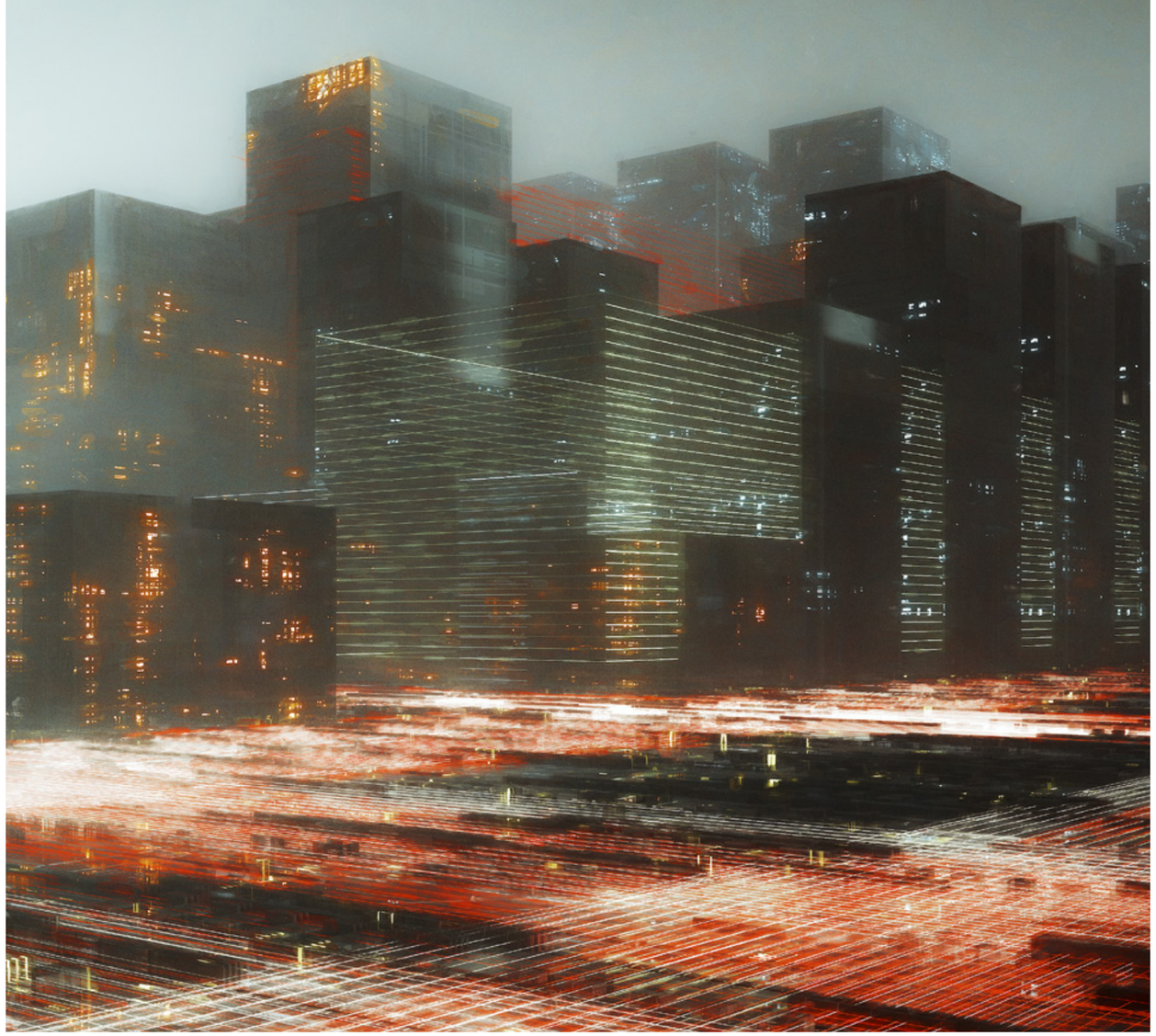
Earn-outs

An earn-out is a common structure whereby a portion of the purchase price is paid at completion and a portion is paid in the future (typically over 1–3 years) with the amount of such "earn-out payments" depending on financial or non-financial performance metrics of the target company after completion. These are bespoke and highly negotiated contractual provisions that depend on the business and financial performance of each business. This is especially relevant for a technology company whose value is usually driven by its rate of growth (measured in e.g. revenues, users or customers) as well as its achieving complex technical and commercial milestones.

For example, an earn-out payment could be drafted to trigger based on:

1. revenue, EBITDA or profit;
2. receiving regulatory approval to enter a new market (e.g. financial regulatory approvals, banking licences for a fintech);
3. customer or subscriber milestones (e.g. a SaaS business); or
4. technical milestones (e.g. an artificial intelligence model).

The earn-out payments can also be linked to retention of key talent (e.g. founders, specialist engineers) post-completion. Typically, the earn-out metric is linked to the buyer's financial model for the acquisition (e.g. if the purchase price is based on a multiple of revenue, then the earn-out target or metric is typically based on revenues over the earn-out period). Earn-out provisions can be a key way to bridge gap between the seller's (at times optimistic) expectations for price and future performance and the buyer's (at times conservative) concern whether the anticipated growth will actually happen. They can clear the way for a transaction to proceed without increasing execution risk by introducing additional conditions precedent, addressing the points as a post-closing financial



true-up once the conditions are satisfied. An earn-out needs to be drafted with care so that there are clear, objective and measurable targets. Care must also be taken as to the governance of the target company during the earn-out period. The buyer will need to have a reasonable degree of autonomy and the seller will require protections so as to ensure the performance of the business is not distorted during the earn-out period – a balance which is always hotly contested. Finally, despite the parties' best intentions, an earn-out will also require a clear dispute resolution mechanism.

Overall, the earn-out is a flexible tool that creates alignment between the buyer and the seller to bridge the valuation gap. An earn-out gives the buyer a degree of protection against over-paying for projected revenues. It may also be a way for the buyer to finance the deferred price using cash generated by the target. The complexity of these provisions can open up significant additional negotiation on the appropriate triggers, how they are determined and anti-avoidance mechanisms.

Contingent value rights (CVRs)

In essence, the CVR is a cousin of the earn-out with all of the pros and cons described above but in the form of a transferable instrument that the buyer issues to the seller at closing. It gives the seller a right to additional payments based on the achievement of specified milestones. Although it is sometimes used in private M&A transactions, it is better known in public M&As for example where a target is a health tech or life sciences company awaiting FDA approval for a medical product. If the approval is obtained before an agreed deadline, then the sellers will be paid an additional uplift to the purchase price. This provides additional contingent value to shareholders and a minority seller can sell the CVR to other sellers or as a listed instrument on the market. However, there is unlikely to be a highly liquid market for CVRs given the inherent complexity of the pricing (which is based on an assessment of the likelihood of any trigger).

Escrow

An escrow provision requires the buyer to deposit a percentage of the purchase price due to the seller into an escrow account (a bank account in the name of a third-party escrow agent) for a set period of time. Typically, the escrow period is the same as the claims period for warranties or indemnities. The escrow agent is paid a fee to hold the funds and to release them only upon satisfaction of specific and narrowly drafted conditions previously stipulated by the parties. Typically, the escrow agent will not accept risk of releasing funds except where it has received a written notice in pre-agreed form from one or both parties.

This can be especially useful in technology transactions where there are a number of smaller sellers (e.g. founders and employees holding shares) as it simplifies the enforcement mechanism and mitigates the credit risk (e.g. pursuing the assets of an employee shareholder post-closing) should the buyer need to pursue a post-closing claim against the seller(s) for breach of warranty or under an indemnity.

Escrow has many of the same downsides for the seller as the earn-out: it defers payment of the full purchase price until post-closing and, if there is any post-closing dispute, escrow may give the buyer leverage to hold up the release of those funds until the dispute is settled.

Revenue sharing

This is a contractual arrangement between the parties to share a percentage of the target company's future revenues between the buyer and the seller (e.g. 10%, 20%). This is helpful in technology transactions where alignment in the post-closing working relationship is critical, for example where the seller continues to jointly develop IP with the target, or licenses IP or supplies services to the target, or where the target otherwise becomes a customer of the seller. This can also be useful where the buyer does not have sufficient cash on hand to pay the full purchase price up front (e.g. as a form of vendor financing in a founder buyout). This has many of the same pros and cons as the earn-out, but with significant flexibility (e.g. it can be tailored to track a revenue stream for a specific product or service). However, this greater complexity comes with greater potential for disputes.

Purchase price adjustments

Purchase price adjustments are a standard feature of M&A transactions. Typically, these adjustments are based on net debt and working capital, but they can also be tailored to include bespoke adjustments to the price. These price adjustments are often used to address value drivers that remain contingent between signing and closing. This approach only works where the value of the contingency can be determined at the time of the closing or the closing accounts.

Anti-embarrassment provisions

A face-saving option for a seller who is not satisfied that the valuation it has shaken hands on with the buyer reflects the long-term prospects of the company is to include an "anti-embarrassment" provision in the transaction documents. If the buyer "flips" (i.e. on-sells) the target business within a certain post-closing period (e.g. 1 to 3 years) for a higher price than the original sale price, this triggers an additional top-up payment from the original buyer to the original seller that reflects a portion of that gain. This can be particularly useful for companies that have been unable to run a full competitive sales process to test the market with satisfactory "price discovery". This scenario can happen in a fluctuating market, a distressed sale, or where the seller needs to divest an asset due to factors outside its control.

Mixed cash and paper consideration

Where the buyer is a growing technology company, a classic method for a buyer to sweeten the deal for the seller without reaching into cash reserves is to pay a portion of the consideration in the form of shares in the buyer. This is more appealing where the buyer is a listed company: no seller wants to be left holding illiquid shares and certain sellers will be unable to do so. Mixed consideration creates alignment between the parties where both of them believe in the overall synergies and future growth potential of the target business in the hands of its new owners. Share consideration can be particularly helpful in allaying a seller's concern that it is selling at a low point in the market cycle, because the buyer is offering shares in the same market.

Vendor financing

This approach has the buyer paying the seller with deferred consideration in the form of repayment over time of a "vendor loan" granted by the seller to the buyer. There is significant flexibility in the terms of these vendor financing arrangements, and they can be as simple as an interest-bearing term loan or as complex as a structured preferred equity instrument that has been optimised for tax and accounting considerations. The risk for the seller is the credit risk of a buyer defaulting on the loan or otherwise failing to repay the loan in full (particularly where the financing is unsecured or subordinate to the buyer's senior debt).

Deferred consideration in the technology sector – Balancing complexity against practicality

In the second part of this article, we highlight some of the key pitfalls when implementing one category of these alternative structures: deferred consideration mechanisms.

A common theme with bespoke structures is the greater the complexity, the greater the risk of a post-closing dispute. In practice, any mechanism that defers the payment of consideration can be seen as providing a buyer with de facto negotiating leverage against the seller. It is therefore critical that these provisions are expertly drafted, because ambiguous provisions could be used to dispute calculated payments and revise the price in the buyer's favour or be used to set off deferred consideration against accumulated rights elsewhere in the transaction documents (e.g. warranty or indemnity claims).

Key pitfalls to anticipate and avoid

Common hotspots in relation to negotiating and implementing deferred consideration mechanisms include:

1. **Payment trigger disputes:** The transaction documents need to set out a clear mechanism for determining whether a deferred payment has in fact been triggered. Getting this mechanism wrong can be value-destructive for either party and so it needs to be thoroughly tested by commercial, accounting and legal teams working together. Post-closing, if the parties are unable to agree when implementing the trigger or mechanism, there will also need to be an efficient and sensible process for the resolution of any disputes, usually by expert determination. The process should be clear and should minimise either party's ability to stall to its advantage. The parties should appoint an independent expert best suited for the purpose (e.g. an accounting firm or investment bank or technical expert) using specific criteria or a pre-agreed list and should provide a solution if the independent expert refuses the appointment or is otherwise unavailable (e.g. due to conflicts).

2. **Unsuitable accounting policies:** Deferred payment structures will usually require the parties to agree on a set of accounting policies that will apply when determining the relevant triggers and calculating payments. Usually, the seller will want to use the accounting policies that applied to the target before closing, because they are familiar and were the basis for its valuation of the target. The buyer will want to use its own policies that it will have imposed from closing. Both positions are defensible; however, parties will often seek compromise by starting from the deal-specific policies agreed in the transaction documents to calculate the purchase price at closing, with appropriate amendments. This will be an important commercial discussion to be settled in the transaction documents.

3. **Unrestricted buyer conduct:** A seller should draft protections that will ensure that, wherever there is deferred consideration, the buyer is required to use appropriate efforts to ensure the triggers are satisfied. Other protections include negative covenants and undertakings to ensure that there are no material changes to the target business (i.e. asset perimeter, business activity) without seller consent during the deferred consideration period. This allows the seller to conduct a true "like for like" comparison when measuring the target's financial or other performance against the deferred consideration metrics.

4. **Unforeseen tax treatment:** The parties should obtain appropriate tax advice with respect to the treatment of any deferred consideration before entering into the transaction. For example, it is important to determine whether the structure and its specific features will result in the full amount of the expected deferred consideration becoming taxable at closing or only upon actual payment, or whether the payments are taxed as income.

Looking ahead

Effectively bridging the valuation gap in technology M&A often demands a combination of financial and legal lateral thinking. Deferred consideration mechanisms can be an indispensable tool to bridge disagreements about valuations. However, such mechanisms are by definition complex and buyers and sellers alike are turning to expert advice to implement structures that achieve the flexibility needed to get deals over the line in the rapidly changing technology sector.

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Closing the deal: Navigating an increasingly complex regulatory landscape

By Steven Vaz and Fiona Garside

In 2025, companies continue to face an increasingly complex regulatory landscape with transactions potentially subject to a growing number of filing requirements in relation to merger control, foreign direct investment (FDI) and the European Foreign Subsidies Regulation (FSR). In most cases, clearances must be obtained before closing.

Merger control

Changes to the UK regime

Some of the core changes introduced by the Updated Regulation come from the broadening of the scope of eligible assets, fund structures and applicable thresholds. These changes are summarised below:

On 1 January 2025, the UK Digital Markets, Competition and Consumers Act 2024 (DMCC Act) amendments relating to merger control came into force. The DMCC Act increases the jurisdictional threshold based on a target's UK turnover to £100 million and creates a new safe harbour from the application of the share-of-supply test for transactions where each party's UK turnover is less than £10 million. It also introduces a new jurisdictional threshold which is designed to enable the CMA to review "killer acquisitions" and which gives the CMA jurisdiction where at least one party (most likely the acquirer) has:

- a share of supply of goods or services in the UK (or a substantial part of the UK) of at least 33%; and
- UK turnover of at least £350 million,

provided that the other party (i.e. the target) has a UK nexus (essentially this requires that the target has activities in, or supplies goods or services in, the UK) (see our June 2024 update).

The UK Government is expected to consult on a new growth-focused strategic steer for the CMA shortly, which will set out the expectations of the CMA in supporting growth across the economy.

Below threshold deals

Regulators worldwide have been grappling with how to approach the perceived enforcement gap for deals which do not meet merger control filing thresholds, but which may have a significant impact on competition. Typically, this involves the acquisition by a large incumbent of an innovative company with low turnover but high competitive potential.

In 2021, the European Commission revised its guidance to encourage referral requests from member states for deals which do not meet EU or national merger control thresholds. The test case for the European Commission's new approach was Illumina's proposed US$8 billion acquisition of GRAIL (a biotech company with no turnover). In September 2024, the Court of Justice of the European Union (ECJ) found that the European Commission cannot examine a merger referred by an EU member state which would not itself have jurisdiction to review the transaction under national merger control rules. See our September 2024 update.

While the ECJ's ruling in Illumina is a significant blow for the European Commission, companies will continue to face uncertainty for below-threshold transactions given the growing trend for competition authorities to have the power to call in transactions which do not meet the usual jurisdictional thresholds. For example, the Italian competition authority has extensive call-in powers and recently referred NVIDIA's proposed acquisition of Run:ai to the European Commission.

FDI

The UK and 24 of the 27 EU member states now have FDI screening mechanisms in place and the remaining 3 (Croatia, Cyprus and Greece) have taken concrete steps towards introducing screening mechanisms. The Irish FDI screening mechanism entered into force on 6 January 2025 and the scope of several regimes has expanded in the last year. In several jurisdictions, internal reorganisations and certain lending transactions can trigger FDI filing requirements.

While the number of notifications has continued to rise in 2024, the number of detailed assessments is relatively low in both the EU and the UK: only 8% of cases notified in 2023 in the EU were subject to a detailed assessment and in the UK less than 5% of notifications reviewed in 2023–24 (41 acquisitions) were called in for an in-depth review under the National Security and Investment Act (NSIA). Remedies are even less common, with less only five final orders imposed under the NSIA in 2023–24. See our October 2024 and November 2024 updates.

The Fourth Annual Report on the EU FDI Screening Regulation (published in October 2024) highlights the broad range of sectors which have been subject to review, including manufacturing, information and communication technologies, financial services, energy, defence, and critical technologies. Similarly, the latest NSIA Annual Report shows that transactions in a wide range of sectors have been called in for review, with defence, military and dual-use, communications and advanced materials representing the largest proportion.

In January 2024, the European Commission published its proposal to strengthen the EU FDI Screening Regulation. The European Commission has highlighted 3 areas of focus: (i) ensuring all member states have a screening mechanism in force, with better harmonised national rules; (ii) identifying key sectors which must be covered by national regimes; and (iii) extending screening to investments by EU investors that are ultimately controlled by non-EU individuals or businesses.

Outbound investment

In January 2025, the European Commission issued a legally non-binding Recommendation which encourages EU member states to adopt screening mechanisms for outbound investments by European investors to third countries for certain sensitive sectors (semiconductors, AI and quantum technologies). The European Commission recommends that the outbound screening mechanisms should apply retroactively to investments made since 2021. Member states have until 15 July 2025 to provide an update on their progress and are expected to submit a comprehensive report by 30 June 2026.

The previous UK Government stated in April 2024 that it would launch a review of outbound investments (see our May 2024 update).

FSR

As the EU FSR has been in force for only a year, the European Commission's practice is still developing. The FSR requires companies with activities in the EU to monitor foreign financial contributions and subsidies that they receive: the notion of financial contribution is broad and includes tax breaks, public support in the context of Covid-19 or the war in Ukraine, the provision of loans or guarantees by the state and the supply of goods/services to the public sector. Companies need to notify in respect of foreign financial contributions received in the context of M&A and public procurement procedures where certain monetary thresholds are met (see our July 2023 update). In the first year, there have been a handful of in-depth investigations.

The information required to report under the FSR is not typically captured in the ordinary course of business. Companies need to collect information on foreign financial contributions for the last 3 years on a rolling basis to enable risk assessments to be carried out before engaging in M&A activity to ensure they are FSR-ready.

Practical considerations

Many merger control and FDI regimes are mandatory and suspensory (i.e. the deal cannot be completed until it has been cleared by the relevant authorities) and there can be substantial penalties for failing to file or wait for clearance. If concerns are identified, then authorities can prohibit the deal or impose remedies, though most deals are cleared without problems. Importantly, the obligation to notify can arise even where there are no substantive concerns, and a local nexus is not always necessary.

With an increasing number of regimes applicable to transactions, it is crucial to consider at an early stage of the deal process which filings might be required, so these can be factored to in the deal timetable, conditions precedent and risk allocation.

In competitive M&A processes, the ability of a bidder to make filings promptly can be critical. Many investors prepare for this by gathering the key information for merger control, FDI and FSR filings in advance, because the entire corporate group or fund platform must be considered.

For investors engaging in regular M&A, it is important to ensure that a consistent approach is taken to where filings are made and what information is provided to regulators, as there is extensive cooperation among regulators.

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Valuation of private fund assets: FCA sends warning to fund managers

The FCA has published the findings from its multi-firm review of valuation processes for private market assets. The FCA has concerns about the potential for conflicts in the valuation of assets and the valuation process where you have private markets and asset managers operating multiple business lines, continuation funds, co-investment opportunities or partnering with other financial institutions.

It considers that robust valuation practices are essential for fairness and confidence in private markets but that this can be complicated in less liquid markets, where judgement-based approaches are employed, and conflicts of interest are not always properly managed.

This review comes against a backdrop of increasing regulatory scrutiny in relation to the growth in private markets, with recent speeches from Bank of England officials and a Bank of England Financial Stability Report citing weaknesses arising from opaque valuations. In February 2025, the FCA issued a portfolio letter to CEOs on its supervisory strategy for asset management and alternatives, calling for firms to consider the findings of this review.

The FCA's review included firms managing funds or providing portfolio management and/or advisory services in the UK for private equity, venture capital, private debt and infrastructure assets. It considered the robustness of firms' valuation processes and governance. It consisted of two phases: a questionnaire to a sample of firms asking for information on their private market activity and their approach to valuing private assets; and an in-depth review of governance and processes through document requests and on-site visits.

Key findings

1. **Inconsistency in valuation practices**

   There was a wide variation in how firms approached valuations, with some lacking robust methodologies.

2. **Governance and oversight**

   Almost all firms had governance arrangements in respect of valuations, but independent committee minutes often failed to record how valuation decisions were reached and record keeping could not show effective oversight of valuation decisions.

3. **Conflicts of interest**

   Some conflicts in the valuation process were identified, while others were only partly identified and documented, with vague descriptions where valuation-related conflicts had been documented. The review refers to conflicts of interest faced by managers of closed-ended funds in the event of a write down of an asset (and a decrease in the value of invested capital and reduced management fees). Firms needed to do better in relation to asset transfers, especially when a manager's valuation determines the transfer price, with the risk of conflict increasing if the manager receives carried interest due to the transfer using unrealised performance. The FCA considers that remuneration linked to valuations can create a conflict, noting a link between remuneration and unrealised performance for investment staff in some cases.

4. **Functional independence and expertise**

   The FCA found only a few firms could show functional independence clearly. This involved a dedicated function or existing control function to lead on valuations, staffed by people with valuation expertise. Firms who fell short of expectations on independence had insufficient expertise in their functions (e.g. could not describe the assets, valuation models in detail).

5. **Policies and procedures**

   The review stresses the importance of clear and appropriate policies, procedures and documentation for the valuation process, with the review finding that policies often did not include a description of safeguards. Although valuation models were documented, the recorded rationales for key assumption changes were sometimes vague. Only a few firms formally incorporated ad hoc valuations into the valuation process and included information on relevant triggers and thresholds.

6. **Application of valuation methodologies**

   The use of methodologies was mostly consistent by asset class, but there were different methodologies for private equity and other areas (e.g. market approach involving comparable sets). The FCA also saw different approaches to reflecting public market volatility.

7. **Use of third-party valuations**

   The review found that reliance on external valuers varied, and some firms did not adequately challenge the valuations provided by external parties. The FCA notes that independence may be limited where a service provider is dependent on the fees from their firm.

Actions for firms

This review and the fact the FCA sent the associated Dear CEO letter emphasise the importance of this. As a result, firms should:

- ensure they have considered the findings of this review, identify any gaps in their policy and procedures and, if necessary, set out a plan to remedy any identified issues.
- consider whether any improvements are needed in: the governance of their valuation process; identifying, documenting, and addressing potential conflicts in their valuation process; ensuring functional independence for their valuation process; and incorporating defined processes for ad hoc valuations.
- ensure this review is noted in the next compliance update to the board or appropriate governance committee, along with the outcome of the internal assessment and any positive or adverse findings and plans to implement any improvements.

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Structuring Shari'ah compliant investment funds

By Dean Moroz, Raheel Butt and Conor Funston

Over the past few years we have seen an increased interest in Shari'ah compliant investment fund structures. The Islamic funds market has experienced substantial growth over the last decade with estimates of assets under management reaching nearly US$200 billion.

Much of this growth has been driven by Gulf Cooperation Council and South-East Asia countries and has been supported by a combination of factors, including increased liquidity in Middle Eastern jurisdictions, depressed asset prices in certain Western jurisdictions resulting from the Covid-19 pandemic, together with an increased focus on ethical investment, which fits well with Shari'ah compliant investment structures. Increased interest and participation in the Shari'ah compliant funds market has come not only from Islamic investors (including sovereign wealth funds, pension funds and high-net-worth individuals from across the Middle East and Asia) but also from fund managers in Western jurisdictions seeking to tap into available liquidity in these markets.

Shari'ah compliant funds provide unique opportunities for both Islamic investors and investors focused on ethical investment opportunities, in addition to funds seeking to access new sources of investment capital.

What are Shari'ah compliant investment funds?

Overview

Shari'ah compliant funds are investment funds which are structured in compliance with, and operate in accordance with, the principles of Islamic Shari'ah – the Islamic legal system derived from the Qur'an and the rulings of Islamic scholars in the form of fatwas. The fund's underlying structure and documentation, as well as the underlying investments made by the fund, must comply with Shari'ah principles.

Typically, the underlying documentation for the fund will include Shari'ah guidelines and investment restrictions to which the fund must adhere in its operations and investments, together with screening criteria to assess the Shari'ah compliance of potential investments. A Shari'ah board will be established for the fund, consisting of one or more Shari'ah scholars who will issue a fatwa, or Islamic juristic opinion, stating their view that the fund structure is in accordance with the principles of Shari'ah. The Shari'ah board will also be responsible for the ongoing monitoring of the fund and its operations to ensure it remains in compliance with Shari'ah.

Key Shari'ah compliance considerations

Although Shari'ah includes a range of principles which are relevant to the Islamic finance market, the following core principles must be borne in mind when structuring Shari'ah compliant funds.

Prohibited sectors

Shari'ah prohibits activities that are deemed to be incompatible with Islamic principles – activities which are harmful or offensive (*haram*) – and prohibits trading in certain goods. The prohibition covers activities relating to tobacco, alcohol, pork and pork-related products, pornography, conventional financial services, arms and gambling.

This element impacts the types of asset classes eligible for investment by such funds. Equity funds for example would face restrictions on investing in companies engaged in prohibited sectors. Real estate funds should ensure that the underlying use of the real estate assets is Shari'ah compliant, i.e. they are not used for *haram* activities, such as operating a casino.

It is invariably the case that many asset types in which a fund may seek to invest, whether that be equity, real estate, ships or planes, may tangentially touch *haram* activities even though this is not their principal purpose or means of generating revenue. For example, a fund may purchase a plane and lease it to an airline for the principal purpose of carrying passengers with revenue generated from the sale of tickets. The sale or serving of alcohol

may however be undertaken as ancillary to its principal operations. Similarly, when looking at corporate equity, the vast majority of companies will have in place some form of conventional banking or financial arrangements, such as interest-bearing debt. If the prohibition were strictly applied, the universe of potential investments would be severely limited. In order to address this, various forms of screening criteria have been developed and may be applied depending on the nature of the fund and the view of the fund's Shari'ah advisors. In the context of equity funds, one example is the Dow Jones Islamic Market Index. The index provides a list of companies permissible for investment based on certain screening criteria, e.g. it has a conventional debt to equity ratio of 33% or less.

Similarly, for funds investing in non-public equity, the fund documentation will include Shari'ah guidelines, investment restrictions and screening criteria. The screening criteria will set out the level of revenue (by reference to a metric such as consolidated total revenues) a portfolio company may derive from *haram* activities before it is considered an unacceptable investment for the fund.

Shari'ah prohibits *riba*

Although most commonly known by its prohibition of the payment or receipt of interest, the prohibition on *riba* is broader than this. It prohibits unjust enrichment, including creating of financial gain through wealth or money alone without risk-sharing linked to a real underlying asset.

This principle has a range of implications when structuring Shari'ah compliant funds. While, at the most basic level, it impacts the types of asset classes eligible for investment by such funds (e.g. restricting equity investments in companies engaged in conventional banking), it also has implications for asset manager compensation structures and traditional equalisation structures typically found in conventional investment funds.

Beyond placing restrictions on investable sectors for the fund, the prohibition on *riba* invariably also impacts the use of conventional leverage at asset level. As noted above, a strict prohibition on any component of interest-bearing debt within the fund structure would severely limit the universe of investable assets or indeed the ability of the asset manager to efficiently manage fund assets where funding, outside capital drawdowns, is required and where Shari'ah compliant forms of funding are not available on commercially acceptable terms or at all. As a result, the Shari'ah guidelines and screening criteria applicable to a fund will typically operate by imposing a cap (by reference to a metric such as the total enterprise value of an asset) on the level of conventional interest-bearing debt permitted at asset holding level.

The prohibition of *gharar*

Gharar refers to the uncertainty, speculation or hazard created by lack of clarity. Shari'ah prohibits transactions which include excessive amounts of uncertainty or speculation. This means that contracts are prohibited where the nature of goods subject to the contract, or their price, existence and timing for payment, is not certain. In addition, it has implications for contracts containing conditional obligations, the triggers for which are not sufficiently certain.

This principle, again, has a range of implications for the structuring and operation of Shari'ah compliant funds, Particularly in terms of eligible asset classes and, more broadly, the impact on the fund's ability to utilise arrangements such as conventional hedging or insurance policies in its operations.

Conventional vs Shari'ah compliant funds

When considering how Shari'ah compliant funds are structured, it is helpful to understand certain key components which are traditionally found in conventional investment fund structures and which are not Shari'ah compliant. Some examples include:

- **Fixed preferred returns**

  In the context of conventional funds, a fixed preferred return is the minimum return in the form of a pre-determined percentage that limited partners in a fund must receive before carried interest can be distributed to general partners – it constitutes the minimum expected return for the investment. In the context of Shari'ah compliant funds, the mechanism is not generally permissible on various grounds, including that it constitutes *riba*, acts as quasi-guarantee of investment returns and violates the risk-sharing principles of Shari'ah.

- **Carried interest**

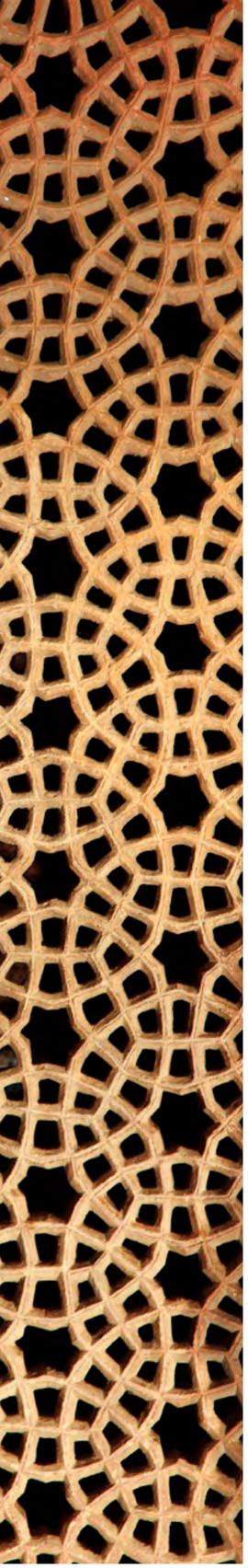
  In conventional fund structures, carried interest is the share of profits earned by general partners as compensation for their role after the hurdle rate is achieved. In the context of Shari'ah, carried interest constitutes *riba* and is therefore prohibited.

- **Equalisation**

  Within the context of conventional funds, the equalisation mechanism operates to adjust the capital contributions of investors who join the fund at different times to ensure that all investors bear risk and return proportionately. It aims to ensure that earlier investors in a fund, who assume higher levels of risk and tie up their capital for longer, are not penalised as against later investors investing in mature portfolios. Typically, equalisation is applied by requiring later investors to provide their capital together with a preferred return component to cover asset investments that have already been made by the fund. Additionally, new investors may be required to pay an equalisation charge on their capital contribution to compensate existing investors for having committed their capital earlier. The equalisation mechanism effectively constitutes an interest compensation charge and, in the context of Shari'ah, is not permissible on the basis that it constitutes *riba*.

Shari'ah compliant solutions

Although the application of Islamic principles in structuring Shrai'ah compliant funds requires some adjustment to conventional fund structures, in practice, Shrai'ah compliant and conventional funds have much architecture and documentation in common. In addition, Shari'ah compliant structuring options are available for use by conventional fund structures and concepts that have been adapted/modified to operate in a Shari'ah compliant manner. Indeed, Shari'ah compliant structures can operate in tandem with, or as a component of, a wider conventional fund that has been so adapted/modified.



Structuring options

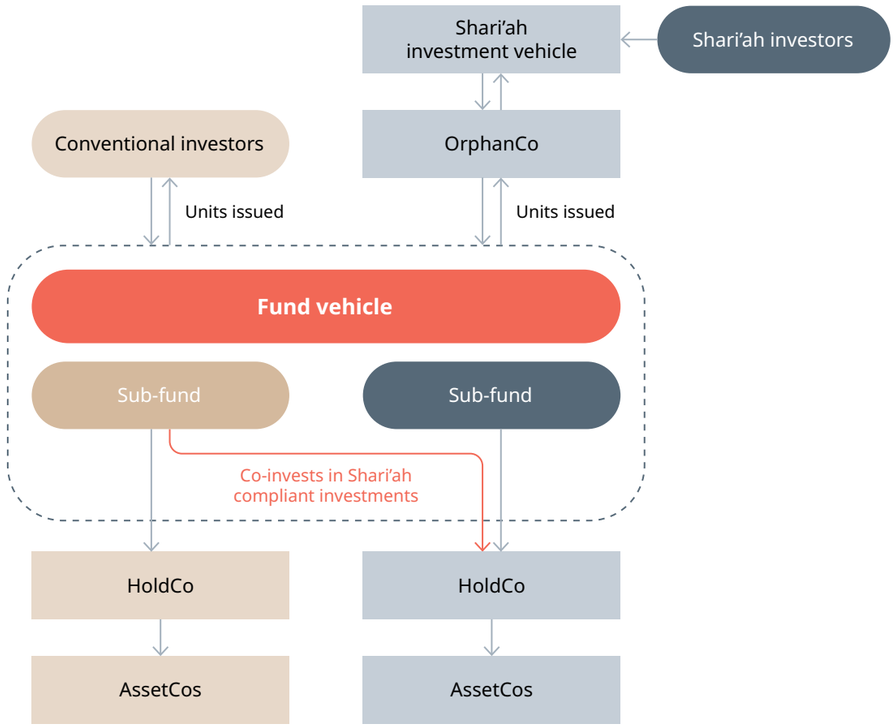
Stand-alone or combined structures

Shari'ah funds can be structured to enable investment in a wide range of asset classes such as corporate equity, infrastructure, real estate and mezzanine financing. The structure adopted in respect of a specific fund will depend on a variety of factors, including the asset investment class and the target market for the fund.

While a fund may be structured as a stand-alone fully Shari'ah compliant fund in circumstances where the target market is limited to Islamic investors, it is also possible to combine Shari'ah compliant and conventional fund structures. This option maximises the universe of potential investors by allowing one structure to be used to tap into both Islamic and conventional markets. Examples include Shari'ah compliant feeder funds and parallel co-investment vehicles operating in conjunction with a conventional fund.

Where a parallel co-investment structure is used, the Shari'ah investment vehicle operates alongside a master fund. The master fund may make both conventional and Shari'ah compliant investments and the Shari'ah investment vehicle may opt to invest in Shari'ah compliant investments made by the master fund. Where a feeder fund structure is used, the Shari'ah compliant vehicle is segregated and provides Shari'ah compliant funding to the fund to make investments.

Below is an example of a co-investment structure utilising sub-funds.



Segregation and special purpose vehicles

As previously noted, given the nature of the real economy and the assets in which funds may invest, it is very challenging to ensure the fund, through its underlying assets, does not touch any *haram* activities. This is one reason why many Shari'ah compliant fund structures use segregation designed to shield Islamic investors from such activities. While this may be achieved in a number of ways, in a stand-alone Shari'ah fund, commonly it is done by separating the asset holding structure for the fund from the Shari'ah funding vehicle through which investors make capital contributions. The asset holding vehicles may be held through an orphan special purpose vehicle on charitable trust. Financing for investment in assets can then be made available from the Shari'ah funding vehicle to the asset holding vehicles with profits and capital repatriated through a combination of Shari'ah compliant *murabaha* and *musawama* arrangements (as described in more detail below). The point at which segregation occurs and the method by which Shari'ah compliant funds are injected into the structure may differ depending on whether the fund is a Shari'ah compliant stand-alone fund, a feeder fund or a parallel co-investment structure.

Shari'ah building blocks

There is a wide range of permissible Shari'ah compliant contract types and arrangements ranging from leases (*ijara*) and development contracts (*istisna*) to partnership type arrangements (*mudaraba*), agency structures (*wakala*) and cost-plus financings (*murabaha*). When structuring Shrai'ah compliant transactions, it is permissible to use a combination of such contractual arrangements as long as that combination does not result in a non-permissible transaction. Shari'ah compliant funds are typically structured using a combination of these contractual arrangements.

Although the specific structure of a given Shari'ah compliant fund will depend on its nature and purpose, Islamic funds are typically structured as limited partnerships using a combination of the following arrangements:

Mudaraba

A *mudaraba* is a form of partnership where one partner or group acts as investor and provides capital (*rabb ul-mal*) and the other uses its expertise to manage the investment (*mudarib*). The arrangement operates in a similar way to a silent partnership with the *mudarib*, as asset manager, managing the investment in accordance with a business plan. Investors are solely responsible for losses while profits may be shared after the return of investor capital, and according to a pre-agreed ratio, between the *mudarib* (as compensation for its expertise) and the investors. It is also possible to structure incentive fees for the benefit of the *mudarib*.

Mudaraba is a key component in the structuring of Shari'ah compliant funds due to its similarity to limited partnerships. Additionally, forms of compensation permissible under *mudaraba* arrangements are not dissimilar, in terms of their economic result, to the carried interest component of compensation employed by conventional funds.

Wakala

A *wakala* is an agency arrangement under which one party or group as principal (*muwakkil*) appoints another (*wakil*) to act as agent. A *wakil* may exercise powers only in accordance with the instructions of the principals. A *wakil* in the context of a fund is akin to the asset manager. Fees payable to a *wakil* may be either fixed or calculated by reference to the net asset value of the fund. The *wakil* may also be entitled to an incentive fee.

Depending on the nature of a particular fund, a *wakala* can benefit the overall structure. Notably, in the context of a fund as *wakil* fees are fixed or calculated, by reference to its NAV, the economic result may not be dissimilar to conventional GP compensation structures.

Murabaha

Murabaha is simply defined as a sale at a mark-up. It is widely used in sales and financing structures. Under a *murabaha* transaction, the financier buys an asset at cost price and then sells that asset to the customer. The financier seeks the financing for the cost price plus a mark-up (or profit). Payment by the customer is on deferred payment terms and may be structured as an instalment, or periodic or bullet payment. The customer is able to realise the cash value of the assets immediately by on-selling them to a third party.

In accordance with Shari'ah principles, the terms of the sale contract under *murabaha*, including the cost price of the asset and the payment terms, must be sufficiently certain at the outset and the profit component must be disclosed.

Murabaha forms a key component of funds in which a segregated structure is used to shield Islamic investors from any *haram* activities at the asset holding level of the fund. *Murabaha* provides the means by which funding can be made available to the relevant holding vehicles for asset acquisitions. The deferred payment obligations under the *Murabaha* enable the return of capital contributions on the sale of underlying fund assets as repayment of the cost price under the *murabaha* with the profits made by the underlying assets being used to return profits to investors.

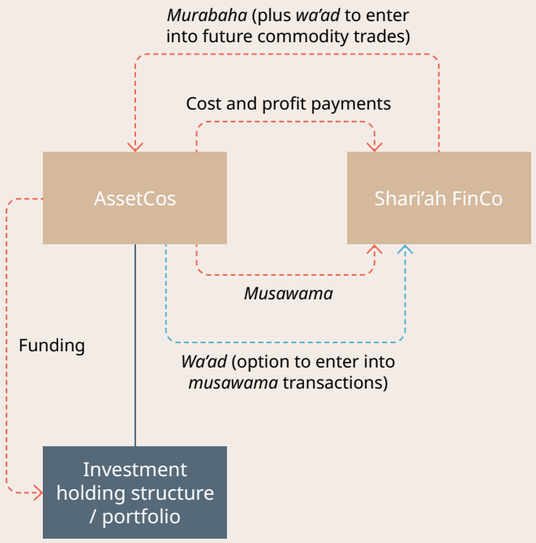
While *murabaha* is a useful tool, it does have constraints when applied to fund structures. In the context of an investment fund, the returns generated by investment assets, both during their term and upon sale, are inherently uncertain. To comply with Shari'ah, the terms of a *murabaha* transaction, including the price and profit component, must be sufficiently certain or known at the outset of the *murabaha* transaction itself. These limitations have been compounded by the adoption of Standard 59 regarding the sale of debt by the Accounting and Auditing Organisation for Islamic Financial Institutions. Standard 59 is directly applicable to many financial institutions across the Middle East and its effect is to limit the ability to use variable profit rates under *murabaha*. As a result, *murabaha* remains a useful tool for providing capital funding to asset investment vehicles and returning such capital with a defined profit component, but it should be used in conjunction with other instruments such as *musawama* (described below) to effectively return profits to investors.

Musawama

Musawama is a type of sales contract under which a financier buys an asset and then sells that asset to the customer. The price payable by the customer is negotiated and agreed without disclosure or reference to the price paid by the financier to acquire the asset. The purchase price typically takes the form of a single payment price, which includes any profit of the financier.

As noted above, when used in the context of Islamic funds, *murabaha*'s ability to return profit to investors is limited. *Musawama*, which does not require disclosure of cost price, may be used to distribute profit and capital gains to investors both periodically during the life of the fund and upon fund dissolution when used in conjunction with *wa'ads* (undertakings).

The below diagram provides an example of a segregated structure using *murabaha* and *musawama* arrangements to fund investments and repatriate capital and profit.



Other considerations

The core considerations applicable when establishing a conventional fund apply equally when establishing a Shari'ah compliant fund, including choice of appropriate jurisdictions for the establishment of fund vehicles and structural considerations designed to minimise tax leakage. While establishing Shari'ah compliant fund structures carries some additional considerations such as the applicability of tax rules in some jurisdictions to certain types of Shari'ah compliant contracts and purification of *haram*-tainted returns, flexible structures are available to address these issues and facilitate access to available capital for investment.

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