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Tangled up in chains?

Making sense of the new UK requirement to keep registers of "people with significant control"

A major new piece of UK company law[1] will come into force on 6 April 2016.[2] New rules will require UK corporate entities – but not corporate entities incorporated outside the UK[3] - to maintain registers of people with significant control (**PSC registers**). Each company's PSC register will, depending on the circumstances, contain the names and "required particulars" of:

- individuals who are "people with significant control" over the company (**PSCs**) – i.e. ultimate beneficial owners; and/or
- "relevant legal entities" who have significant control over the company (**RLEs**).

The PSC register will be required to be kept at a company's registered office (available for public inspection) or at Companies House (the public register of UK companies).

The new rules only relate require personal information relating to an individual who is a PSC (including *name*, *address*, *nationality* and *date of birth*) to be made publicly available. This will prove problematic if there is a desire to keep such information confidential. It should also be noted that using foreign companies in a chain will not prevent disclosure.

The UK Government's stated aims behind the new rules are to tackle tax evasion, money laundering and terrorist financing, as well as to improve the investment climate and make doing business easier. These are undoubtedly laudable aims. However, the rules are lengthy and intricate and there is a risk that applying them in practice will be confusing, time-consuming and costly. This is especially so in relation to more complex structures where there are chains of companies with some companies incorporated in the UK and others incorporated elsewhere. Indeed, to many the new rules may represent an additional, and unwelcome, administrative burden. The new rules enact certain obligations of the UK Government under the fourth Anti-Money Laundering Directive but this is not complete, and the regime will need to be revisited within the next year to ensure full compliance with the Directive.

The concepts at work are best illustrated by reference to examples. In this article we focus on limited companies, distil the rules down to the key principles and explain how the rules work by reference to a number of scenarios. In the diagrams that follow, blue represents individuals, green represents UK private limited companies and red represents foreign companies (i.e. companies not incorporated in the UK). Where a percentage is shown this indicates the percentage of issued ordinary voting shares held.

We recommend that detailed legal advice is sought to assess how the new rules will apply in a given scenario. However, we hope this article provides a useful overview of the rules and what they are trying to achieve.

[1] Part 21A Information About People with Significant Control and Schedule 1A References to People with Significant Control Over a Company inserted into the Companies Act 2006 (**CA 06**) by the Small Business, Enterprise and Employment Act 2015

[2] The obligation to file information at Companies House will not take effect until three months later. Note that the rules were originally scheduled to come into force in January 2016.

[3] That is companies incorporated under the UK Companies Acts including LTDs/PLCs, companies limited by guarantee, unlimited companies, limited liability partnerships and Societas Europaea but excluding listed PLCs to which DTR 5 (Chapter 5 of the FCA's Disclosure Rules and Transparency Rules sourcebook) applies and which are therefore already subject to disclosure obligations (e.g. LSE main market and AIM companies) (**DTR 5 Issuers**).

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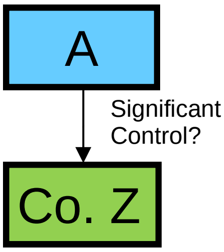
1. People with "significant control" (PSCs)

Only individuals (i.e. natural persons) can be "people with significant control" in relation to a company.



So who counts as a PSC? An individual (**A**) will have "significant control" over a company (**Company Z**), and therefore be a PSC in relation to it, if any of the following five conditions are met:

1. **Share ownership**: A holds, directly or "indirectly" (see below), more than 25% of the shares in Company Z.

2. **Voting rights**: A holds, directly or indirectly, more than 25% of the voting rights in Company Z.

3. **Rights to appoint/remove directors**: A holds the right, directly or indirectly, to appoint or remove a majority of the board of directors of Company Z.

4. **Significant influence or control**: A has the right to exercise, or actually exercises (presumably where there is no underpinning legal right), "significant influence or control" (see below) over Company Z.

5. **Control of a trust/partnership**: This is a two limb test:

    - The trustees of a trust or members of a "firm" (which for simplicity we shall treat in this article as being an unincorporated partnership) which in either case does not have separate legal personality meet any of the other four conditions in relation to Company Z, or would do so if they were individuals (if the trustees or members are corporate entities); <u>and</u>

    - Individual A has the right to exercise or actually exercises "significant influence or control" over the activities of the trust or partnership.

Let's call these conditions the **Significant Control Conditions**.

The phrase "significant influence or control" used in Conditions 4 and 5 has been defined in draft statutory guidance published by the Government. A summary of the statutory guidance is set out below.

2. Holding shares/rights "indirectly" – majority stake

Individual A is treated as indirectly holding shares in, or rights in relation to, Company Z if A holds a "majority stake" in a "legal entity" that holds shares in, or rights in relation to, Company Z.

A "legal entity" is a body corporate or partnership that is a legal person under the law by which it is governed. For simplicity, let's assume that such legal entity is a UK private limited company and is a parent company of Company Z (**Company Y**).

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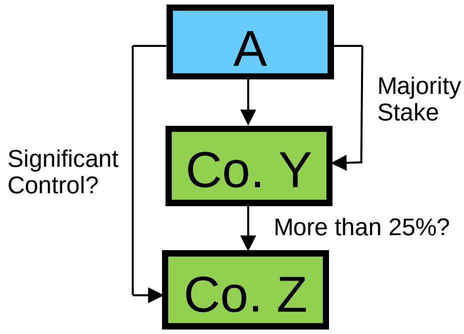


Individual A has a "majority stake" in Company Y if any of the following four conditions are met:

1. A holds a majority of the voting rights in Company Y.

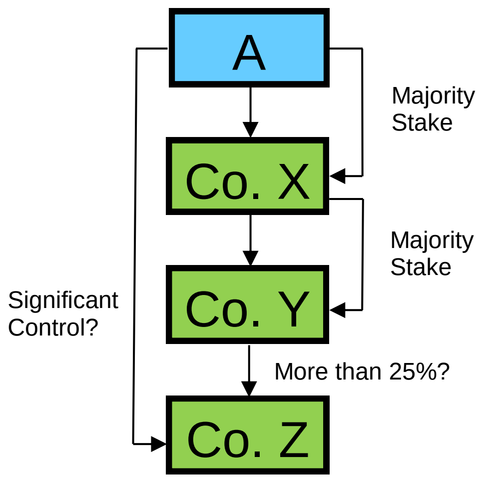
2. A is a member of Company Y and has the right to appoint or remove a majority of the board of directors of Company Y.

3. A is a member of Company Y and controls alone, pursuant to a shareholders'/members' agreement, a majority of the voting rights in Company Y.

4. A has the right to exercise, or actually exercises, "dominant influence or control" over Company Y.

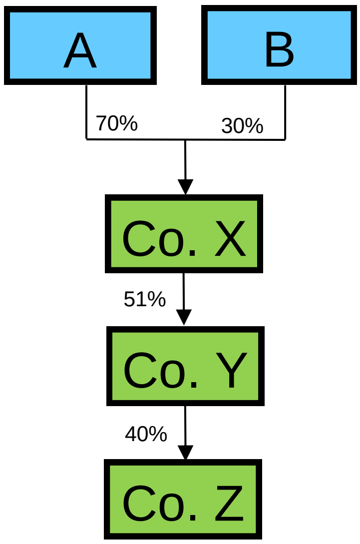
Let's call these the **Majority Stake Conditions**.

As shown below, these rules are applied to chains of companies such that A will be treated as indirectly holding shares in, or rights in relation to, Company Z if there is another company between A and Company Y (**Company X**) and A holds a majority stake in Company X which in turn holds a majority stake in Company Y etc. The rules work so that, in effect, A is treated as "stepping into the shoes" of companies further down the chain for the purposes of assessing whether A is a PSC in relation to a given company.



For the purposes of this article, and again to keep things simple, we will focus on Majority Stake Condition 1. In the examples that follow we assume that each company only has ordinary shares with equal voting rights in issue and therefore a majority stake is achieved by holding more than 50% of the shares in that company.

Let's now turn to a more complicated example to see how the significant control and majority stake concepts interact.



In this example:

- Individual A is a PSC in relation to Company Z because A is treated as indirectly holding 40% of the shares in Company Z. This is because A holds a majority stake in Company X, which holds a majority stake in Company Y, which holds 40% of the shares in Company Z (i.e. more than 25%, which - as we've seen above - meets Significant Control Condition 1).
- A is a PSC in relation to Company Y because A is treated as indirectly holding 51% of the shares in Company Y. This is because A holds a majority stake in Company X, which holds 51% of the shares in Company Y (meeting Significant Control Condition 1).
- A is a PSC in relation to Company X. This is because A holds 70% of the shares in Company X (meeting Significant Control Condition 1).
- Individual B is not a PSC in relation to Company Z or Company Y because B does not hold a majority stake in Company X and therefore also does not hold a majority stake in Company Y.
- However, B is a PSC in relation to Company X because B holds 30% of the shares in Company X (meeting Significant Control Condition 1).

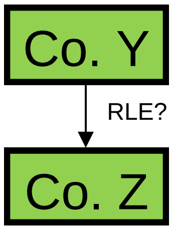
3. "Relevant legal entities" (RLEs)

Another key concept in the rules is that of a "relevant legal entity". A legal entity (see (2) above) is a RLE in relation to company required to maintain a PSC register. A company (**Company Y**) will be a RLE in relation to another company (**Company Z**) if:

- Company Y would be a PSC in relation to Company Z by meeting one of the Significant Control Conditions if Company Y was an individual;

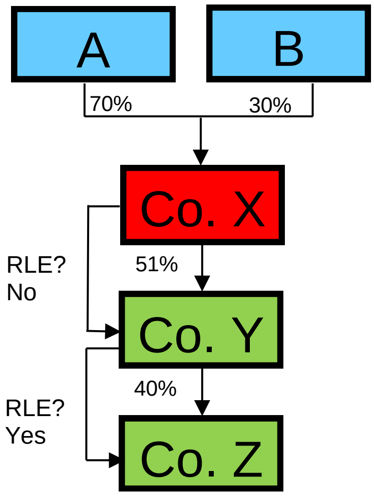
 AND

- Company Y is "subject to its own disclosure requirements".



In broad terms, Company Y will be subject to its own disclosure requirements if the PSC rules apply to it (i.e. it's a UK company etc.) or it is a DTR 5 issuer. Foreign companies are therefore not at present generally capable of being RLEs. A DTR 5 issuer could of course be a non-UK company and the rules also grant the power to add certain foreign companies to the list of RLEs but to keep things simple though let's assume that a foreign company cannot be a RLE.

Let's now turn back to the example to see how these rules apply but this time let's make Company X a foreign company.



- Company Y is a RLE in relation to Company Z. This is because:
    - Company Y has significant control over Company Z (i.e. it would be a PSC if it were an individual); and
    - Company Y is a UK company and is therefore subject to its own disclosure requirements under the PSC rules.
- However, Company X is not a RLE in relation to Company Y. This is because:
    - although Company X has significant control over Company Y (i.e. it would be a PSC if it were an individual);

- Company X is not a UK company and therefore is not subject its own disclosure requirements under the PSC rules.

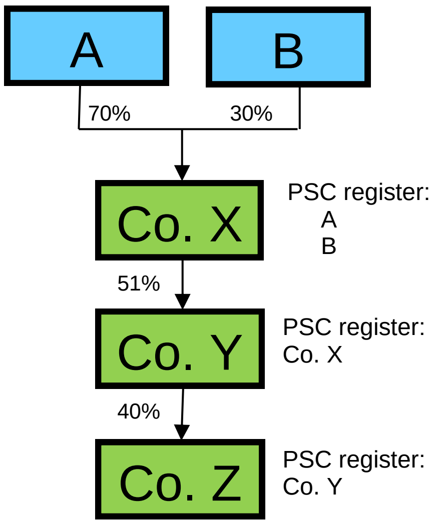
4. Does a PSC/RLE need to be registered on a company's PSC register?

As you have seen, identifying PSCs and RLEs is not too difficult. However, just because a person is a PSC or RLE in relation to a company does not mean that the PSC/RLE should be entered onto that company's PSC register. Under the rules a PSC or RLE is either "registrable" or "non-registrable" in relation to a company.

In broad terms, the rules work so that:

- A PSC/RLE will only be registrable in relation to a company if the PSC/RLE holds the interest in the company other than through a chain of other RLEs.
- This means that if there is a clear line of UK companies, each with their own PSC register, all the way to the PSC at the top of the chain, then each company need only enter on its PSC register either the PSC or RLE immediately above it. The rules work to avoid unnecessary duplication at the various levels up the chain.
- However, if there is a foreign company somewhere in the chain then the ability to trace to the top potentially breaks down at that level (as the foreign company may not be subject to its own disclosure requirements) and then both any PSC at the top and all RLEs further up the chain become registrable on the PSC register of a company below the foreign company.

To show this let's look at some examples.



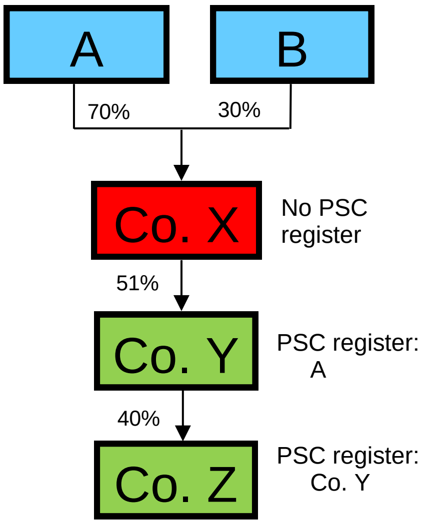
In this example:

- You will see that there is chain of UK companies all the way to the two individuals at the top.
- Let's first consider the PSC register of Company Z:
    - A is a PSC in relation to Company Z by holding the shares in Company Z indirectly for the purposes of Significant Control Condition 1.
    - B is not a PSC in relation to Company Z because B does not hold a majority stake in Company X (because Majority Stake Condition 1 is not met) and therefore does not hold shares in Company Z indirectly.

- ○ Company Y is a RLE in relation to Company Z (because it would be a PSC in relation to Company Z were it an individual).
- ○ Who goes on the PSC register? Only Company Y. Individual A is non-registrable in relation to Company Z because you can trace A via the PSC register of Company X and Company Y.

- The same analysis applies for the PSC register of Company Y:
  - ○ A is a PSC in relation to Company Y by holding the shares in Company Y indirectly.
  - ○ B is not a PSC in relation to Company Y.
  - ○ Company X is a RLE in relation to Company Y.
  - ○ Who goes on the PSC register? Only Company X. A is non-registrable in relation to Company Y because you can trace A via the PSC register of Company X.
- Let's now consider the PSC register of Company X:
  - ○ A is a PSC in relation to Company X.
  - ○ B is a PSC in relation to Company X.
  - ○ So who goes on the PSC register? Both A and B.

Contrast this with the next example where Company X is a foreign company.



In this example:

- There is no longer a chain of UK companies all the way to the two individuals at the top.
- Company X will not have a PSC register because it is a foreign company.
- This time, let's first consider the PSC register of Company Y:
  - ○ A is a PSC in relation to Company Y by holding the shares in Company Y indirectly.
  - ○ B is not a PSC in relation to Company Y because B does not hold a majority stake in Company X.
  - ○ Company X is not a RLE in relation to Company Y because it is a foreign company.
  - ○ Who goes on the PSC register? Only A as a PSC in relation to Company Y. Company X is not a RLE in relation Company Y.

- Let's now consider the PSC register of Company Z.
    - A is a PSC in relation to Company Z by holding the shares in Company Z indirectly. Note that it makes no difference that the shares are held through a foreign company and so inserting a foreign company into a chain will not defeat the rules.
    - B is not a PSC in relation to Company Z because B does not hold a majority stake in Company X.
    - Company Y is a RLE in relation to Company Z.
  - Who goes on the PSC register? Company Y as a RLE is registrable and therefore should be included on Company Z's PSC register. Individual A (as a PSC) is non-registrable but can be traced by looking up the chain at the PSC register of Company Y.[4]

5. Statutory Guidance

The Department for Business Innovation & Skills released in late January 2016 an updated '*Draft Statutory Guidance on the meaning of "Significant Influence or control" over companies in the context of the Register of People with Significant Control*' (**Guidance**). This draft follows a period of consultation on an earlier draft of the Guidance released in December. Absent any changes introduced by Parliament, it will be the final form of statutory guidance on interpreting the phrase "significant influence or control" and will therefore serve an important function. BIS has issued a variety of other non-statutory guidance on the workings of the legislation.

The purpose of the Guidance is to set out the meaning of the words "significant influence or control" for the fourth and fifth tests in the legislation for determining whether an individual is a PSC. The first three tests require, in broad terms, the holding of more than 25% of the shares or voting rights in the company or the right to appoint or remove a majority of the board of the directors.

In respect of the terminology used, the Guidance states that "significant influence" and "control" are alternatives and that:

- where a person can ensure that a company, trust or partnership generally adopts the activities which that person desires, this will be indicative of "significant influence";
- where a person can direct the activities of a company, trust or partnership, this will be indicative of "control"; and
- "significant influence" and "control" do not have to be exercised by a person with a view to gaining economic benefits.

The Guidance is not exhaustive and simply provides a number of principles and examples which are indicative of when the fourth and fifth tests will be met. Therefore, a decision in many cases will be fact specific and judgment will be required.

The Fourth Test - Significant Influence or Control over a Company

This is a catch-all test and aims to pick-up circumstances which are not covered by the first three (more narrow) tests. It looks at the much broader concept of significant influence or control over a company even if those previous tests have not been met.

There are two tests for whether a person has significant influence or control over a company. The first looks at whether an individual has a right (i.e. a legal, enforceable right) to exercise significant influence or control. The second looks at the position in reality – i.e. when there is no legal right – to see whether in practice significant influence or control is exercised by a person.

[4] This reflects the position following the amendments made by The Companies Act 2006 (Amendment of Part 21A) Regulations 2016 (SI 2016/136).

A right to exercise significant influence or control

Absolute decision rights (i.e. without the need to refer to or collaborate with somebody else) over matters relating to the running of the business may mean that a person has control. The specific examples in the Guidance include decisions in relation to adopting or amending a business plan, changes in the nature of the company's business, the appointment or removal of the CEO or even additional borrowing. Veto rights over similar matters are also covered. It is not entirely clear from the examples in the Guidance where the line should be drawn; if for example the only right granted to a person is to prevent additional borrowing, it seems unusual for that alone to give a person the relevant level of control. However, one would need to look at the particular facts.

However, where veto rights (such as those referred to above) have been granted for the purposes of protecting a "minority interest", this will not trigger the operation of the rules and a person will not have control. Again, it is not entirely clear where the line is drawn and the Guidance does not specify what will constitute a minority interest for these purposes.

Actual exercise of significant influence or control

Where an individual does not have a legal right to exercise significant influence or control, they may nonetheless in practice exercise such influence or control that they should be seen as a PSC. The first aspect to look at is whether as a result of the cumulative effect of relationships that a person has with a company one would say that he is a PSC. The example given is a director who owns key assets of the business; the combination of his influence may mean that in practice he is a PSC.

Shadow directors are also caught by these rules but the Guidance goes further than that and includes all persons who are significantly involved in the management and direction of the company. In a test which is different to and more extensive than that for shadow directors, the guidance states that a person who "regularly or consistently directs or influences a significant section of the board, or is regularly consulted on board decisions and whose views influence decisions made by the board" may be a PSC. At shareholder level where the recommendations of a person are always (or almost always) followed by shareholders holding a majority of the voting rights, then that person may too be a PSC.

The Fifth Test – Trusts and Partnerships

This condition has particular application for trusts and partnerships which do not have not separate legal personality. Note that a limited partnership in the United Kingdom falls within this treatment and the person who controls the management or activities of a limited partnership - in most cases the general partner – will be the PSC. To apply this test:

- First, check whether the trustees of the trust or members of the partnership meet any of the other four tests in relation to a company, or would do so if they were individuals (if the trustees or members are corporate entities) – i.e. check whether they would be PSCs.

- Secondly, check whether an individual – other than a trustee or member of the partnership - has the right to exercise or actually exercises significant influence or control over the activities of the trust or partnership.

If an individual does meet that second limb, then that individual will be a PSC in relation to the company.

A right to exercise significant influence or control

Again, the rules distinguish between a legal right and the practical exercise of significance influence or control. Where a person has the right to direct or influence the running of the activities of the trust or partnership, they may be a PSC. Examples of such a right include a right to:

- appoint or remove any of the trustees or partners;
- direct the distribution of funds or assets; and
- amend the trust or partnership deed.

Again, where the line is drawn in each of these particular points is a key question and will, in most cases, turn on the facts. There is no need for a right to have been exercised for the rules to apply.

It is not unusual for a settlor to reserve the right to remove the trustees and replace them with other trustees. This right is likely to mean that such a settlor will be treated as a PSC and therefore this test potentially captures settlors in a way that we presume had not been anticipated. Similarly, where other material rights are reserved to a settlor or a protector, that too may meet the conditions and require disclosure of the name of that person as a PSC in the UK company's register.

Actual exercise of significant influence or control

The Guidance provides that a person is likely to exercise significant influence or control over a trust or partnership if they are "regularly involved in the running of the trust or firm [i.e. partnership]". For example, a person who issues instructions as to the activities of the trust, which are generally followed, will be caught. It is clear therefore that there must be active involvement of a person and the trustees must generally follow the instructions of that person. This two stage test is helpful as it requires a clear and regular pattern of behaviour from the individuals and a causal link with the actions of the trustees (and presumably independent decision making by the trustees will be largely absent, which may well be tantamount to trustees having abrogated their duties).

6. Conclusion

There is a lot of additional detail within the rules not covered in this article but we hope that the above provides a useful overview of the way the rules work and helps untangle at least some of the complexity.

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