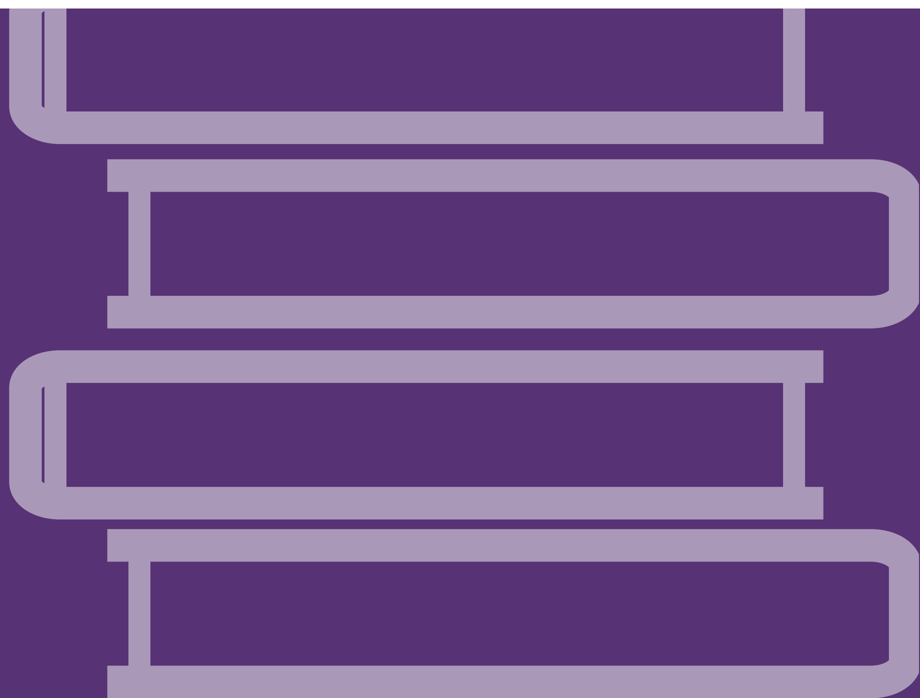
British Private Equity & Venture Capital Association



Policy & Technical Bulletin

Keeping you at the forefront of private equity and venture capital in the UK

May 2021 ////

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Introduction

Welcome to the BVCA Technical Bulletin, a collection of in-depth articles by members of the BVCA and our three technical committees: Regulatory; Legal & Accounting; and Taxation. Our goal is to keep BVCA members informed of the key topics on the committees' agendas, how they impact the private equity and venture capital industry, and how the BVCA and committee members are engaging with policymakers and regulators. The Bulletin is published twice a year.

Over the last year we have seen our industry navigate and adapt well to a challenging and uncertain climate. The COVID-19 pandemic continues to impact the way we work but with the number of cases falling, restrictions easing and the vaccination programme gathering pace, the UK is beginning its recovery with continued investment from the private equity and venture capital ("PE/VC") industry.

The Taxation Committee engaged with policymakers in the run up to the 2021 Budget, alongside the political advocacy from the BVCA team (including the 'New Horizons' report). No changes to capital gains tax and the treatment of carried interest were announced or proposed at either the Budget on 3 March or in the further consultations published on 23 March. There were positive developments related to consultations covering VAT grouping and uncertain tax positions and more information is in the March Policy & Technical Update. The BVCA Budget submission included several representations on how to improve the competitiveness of the UK asset management industry for PE/VC. Developed across all three technical committees, these recommendations and more were also included in our feedback to HMT's review of the UK funds regime and are covered in the first article.

Alongside the areas covered in more detail in this Bulletin, the Taxation Committee has: continued to respond to consultations relating to the UK's asset holding company regime; provided members with updates on the 2019/20 partnerships tax returns filing process for non-resident partners; and continued its engagement with domestic and global stakeholders on the OECD's Digitalisation Programme.

In their article, Matthew Saronson and Veronika Polakova provide insight on the US withholding regime and the treatment of partnership interests. Whilst the regime has been in place since 2017, the details of the implementation have remained unclear and led to multiple cases to address uncertainty and establish exemptions. The article explains the details of the final regulations released in January, and how partnerships can and should establish exemptions. As a follow up to the EU Mandatory Disclosure rules ("DAC6") article published in the November 2020 Bulletin, Jose Maria Palicio and Paul Eastham reflect on the last six months and discuss recent trends and how sponsors have adjusted to the UK's replacement regime.

December 2020 saw the UK and EU agree on a trade deal that removes tariffs and quotas on most goods. The deal does not cover financial services, but a MoU has now been agreed covering co-operation and dialogue between the two jurisdictions. Over the last six months, the Regulatory Committee has been deeply involved in discussions about how the UK's regulatory framework might need adjusting for the UK's new position outside the EU. This has involved the committee responding to a Treasury Select Committee inquiry into the Future of Financial Services and HMT consultations on the Financial Services Future Regulatory Framework, Solvency II, the Overseas Framework and the UK funds review. This increased focus on regulatory change in the UK has not been accompanied by corresponding decline in the relevance of EU matters, with the committee contributing heavily to the industry response to the European Commission's review of

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Tim Lewis
Chair, Regulatory Committee

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the AIFMD framework. We worked very closely with Invest Europe and other industry associations and the key message was that the existing rules are mostly fit-for-purpose and there is no justification for amending the level 1 legislative framework. We highlighted the importance of cross-border investment flows and that the delegation model should not be made more restrictive and that national private placement regimes should remain open. Legislative proposals are expected later this year.

Facilitating access to DC pension schemes for PE/VC funds remains another important area of focus. The Regulatory Committee recently responded to a further DWP consultation on the charge cap (that applies to the default auto-enrolment DC schemes), which proposed a new multi-year smoothing mechanism for performance fees, alongside the removal of the 'look through' for performance fees in venture capital and growth equity funds of funds. Tom Taylor's article presents the case in favour of DC schemes investing in PE/VC funds and outlines the BVCA's participation in the Bank of England, the UK Financial Conduct Authority and HMT Productive Finance Working Group. The group is playing an important role in the ongoing creation of a new Long-Term Asset Fund, which may help remove some of the barriers to DC schemes investing in PE/VC funds.

Another topic at the top of the Regulatory Committee's agenda is the development of sustainability regulation in both the UK and the EU. On the UK side, the committee has been liaising regularly with HMT and the FCA on the UK's plans for climate-related disclosures across the UK economy, as foretold by the Government's Task Force on Climate-related Financial Disclosure ("TCFD") Roadmap, which Tim Lewis's article covers in detail. Alongside the Legal & Accounting Committee, the Regulatory Committee also contributed to the BVCA response to BEIS' consultation on requiring climate-related disclosures by large private companies in the UK. Meanwhile, the committee has remained engaged on the development and impact of the EU's Sustainable Finance Program, particularly as regards the Sustainable Finance Disclosure Regulation and the EU Taxonomy.

The FCA has further developed its proposals for new prudential rules for MiFID investment firms, which will require affected firms to look at various prudential issues, not least their capital requirements and remuneration structures, from 1 January 2022. As well as responding to the FCA's ongoing consultations introducing the UK Investment Firm Prudential Regime ("IFPR"), the committee has also contributed to Invest Europe's response to an EBA consultation on remuneration guidelines under the EU Investment Firms Directive and the Investment Firms Regulation. James Smethurst's article summarises the state of play as regards IFPR.

The Legal & Accounting Committee has responded to several consultations in recent months covering areas that impact transactions/M&A and portfolio companies, as well as monitoring the impact of COVID-19 and supporting the work on access to DC pensions. Reforms to requirements relating to corporate governance, reporting and audit in the UK are aimed at making directors of the country's biggest companies (listed and private) more accountable, and improving the audit market. A recent BEIS consultation aims to implement most of the recommendations of the Kingman, Brydon and CMA reviews into this area. In this Bulletin, we cover the key areas in the consultation and the impact these recommendations may have on the PE/VC industry.

The National Security & Investment Act received Royal Assent in May and the BVCA continues its engagement with government on the implementation of the new regime, including as a member of a BEIS Expert Panel. In her article, Amy Mahon discusses the changes to the original bill, which we advocated for, and the BVCA's work on the definitions of mandatory sectors requiring notification.

Camilla Barry, in her article, covers The Pensions Regulator's approach to the investigation and prosecution of new criminal offences introduced in The Pension Schemes Act 2021. The new offences of "avoiding an employer debt" and "conduct risking accrued scheme benefits" are unclear and could criminalise normal commercial activity.

Another area of focus for the Legal & Accounting Committee has been on corporate transparency and register reform, with the committee responding to multiple consultations as well as continued engagement with BEIS. Victoria Sigeti, Tom Alabaster and Yasir Aziz provide insight into three recent consultations on reforming the powers of the Registrar (Companies House), implementing a ban on corporate directors and improving the quality and value of financial information on the UK companies register.

To conclude this Bulletin, Tom Alabaster provides our regular case law update. Please note that the Legal & Accounting Committee continues to publish monthly accounting and legal updates, which are available on the BVCA website.

Our committee members

The BVCA is immensely grateful for the time, enthusiasm and expertise of members of the technical committees as their work is crucial to our political engagement and advocacy activities. We would like to thank all members that have served on the technical committees, including those who have recently stepped down, for their considerable contributions.

	New members on our committees	Members who stepped down
Legal & Accounting Committee	**Vikas Karlekar** (ICG)	
Regulatory Committee		**Paul Cook** (YFM Equity)
Taxation Committee	**Ed Nevens** (Cinven) **Josh Griffin** (Inflexion)	**Caroline Conder** (LDC)

We would also like to extend our thanks to the excellent secretariat at the BVCA who support the work of our three committees so well.

If you have any questions, or would like to get more involved in the work of the committees and their working groups, please feel free to get in touch with any of us.

With best wishes,

Amy Mahon
Chair,
Legal & Accounting Committee

Mark Baldwin
Chair,
Taxation Committee

Tim Lewis
Chair,
Regulatory Committee

Gurpreet Manku
Deputy Director General,
BVCA

Submissions over the past six months

The list below highlights the submissions the BVCA has made and contributed to since the start of December 2020 (as our last Bulletin was published in November 2020). You can find all of the BVCA's policy submissions here and the Invest Europe/Public Affairs Executive ("PAE") submissions here. The PAE consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations across Europe. The PAE represents the views of this industry in EU-level public affairs and the BVCA is a member of and regular contributor to this group.

The BVCA also provides members with monthly updates on all of our submissions and key consultations. Please sign up for the monthly Policy & Technical update here to receive these updates.

Committee	Specific consultation topic
Taxation	• **HMT** – Enterprise Management Incentives call for evidence • **HMT** – Tax Treatment of Asset Holding Companies in Alternative Fund Structures • The committee also published a response to the **OTS** first report on the Capital Gains Tax review and member updates on the 2019/20 partnership tax returns filing process for non-resident partners. • **OECD** – Reports on the Pillar One and Pillar Two Blueprints
Regulation	• **FCA** – Second consultation on the Investment Firm Prudential Regime • **ESAs** – Disclosures regarding funds with environmental objectives • **DWP** – Incorporating performance fees within the charge cap • **HMT** – Implementation of Investment Firms Prudential Regime and Basel 3 Standards • **HMT** – Overseas Framework call for evidence • **Treasury Select Committee:** Future of Financial Services • **HMT** – Financial Services Future Regulatory Framework Review Phase II • **HMT** – Review of Solvency II • **FCA** – A new UK prudential regime for MiFID investment firms • **Invest Europe/PAE response to ESMA** – Guidelines on marketing communications under the Regulation on facilitating cross-border distribution of collective investment undertakings. • **EC** – Public consultation on the review of AIFMD

Committee	Specific consultation topic
Legal & Accounting	• **FCA** – Investor protection measures for special purpose acquisition companies: Proposed changes to the Listing Rules • **IFRS** – Post Implementation Review of IFRS 10, 11 & 12 • **BEIS** – Mandatory climate-related financial disclosures by publicly quoted companies, large private companies and LLPs • **The Pensions Regulator** – Approach to the investigation and prosecution of the new criminal offences • **BEIS** – Subsidy Control: Designing a new approach for the UK • **BEIS** – Measures to reform post termination non-compete clauses in contracts of employment • **BEIS** – Corporate Transparency and Register Reform: improving the quality and value of financial information on the UK companies register • **BEIS** – Corporate Transparency and Register Reform: implementing the ban on corporate directors • **BEIS** – Corporate Transparency and Register Reform: powers of the registrar • **BEIS** – NSI: Sectors in Scope of the Mandatory Regime
Cross-committee	• **HMT** – Review of the UK funds regime

Legal & Accounting Committee

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Angel Quek	Latham & Watkins
Ashley Coups	EY
Babett Carrier	Cinven
Benjamin Marten	Bridgepoint
Chris Bulger	Vitruvian Partners
Ed Hall	Goodwin Procter
Elizabeth Judd	STAR Capital
Geoffrey Kittredge	Debevoise
James Douglas	Linklaters
John Atherton	Ares Management
John Heard	Abingworth
Jonathan Martin	KPMG
Jonny Myers	Clifford Chance
Karen Sands	Hermes GPE
Nick Reid	Carlyle
Richard Mcguire	PwC
Steven Smith	Macquarie
Tom Alabaster	Ropes & Gray
Victoria Sigeti	Freshfields Bruckhaus Deringer
Vikas Karlekar	ICG
Yasir Aziz	Deloitte

Regulatory Committee

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Andrew Lewis	ICG
Christopher Crozier	Permira
Ed Kingsbury	CMS
James Smethurst	Freshfields Bruckhaus Deringer
John Decesare	3i
John Morgan	Pantheon
Lindsay Hamilton	Livingbridge
Mark Howard	KKR
Matthew Cottrell	Carlyle
Neel Mehta	DWS Private Equity
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Paul Ellison	Clifford Chance
Peter Moore	Cinven
Simon Powell	Advent International
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Alexander Cox	Ashurst
Alexandra Hone	ICG
Anthony Stewart	Clifford Chance
Craig Vickery	Exponent
Ed Nevens	Cinven
Elaine Gwilt	KPMG
Eli Hillman	Grant Thornton
Gareth Miles	Slaughter & May
Garry O'Neill	3i
Graham Iversen	Greenberg Traurig
James Pratt	BDO
James Sanderson	Vitruvian Partners

Jenny Wheater	Debevoise
Jessica Haigh	Permira
Jill Hardie	Aberdeen Standard Investments
Jonathan Page	PwC
Jose Maria Palicio	Permira
Josh Griffin	Inflexion
Maria Carradice	Mayfair Equity Partners
Matthew Saronson	Debevoise
Michael McCotter	Charterhouse Capital Partners
Paul McCartney	EY
Richard Vitou	Deloitte
Russell Warren	Travers Smith
Stephen Pevsner	Proskauer
Tim Hughes	PwC
Tim Lowe	Kirkland & Ellis
Tony Mancini	KPMG
Rhiannon Kinghall Were (Secondee)	Macfarlanes

01.

Review of UK funds regime

Gurpreet Manku (BVCA)

01. Review of UK funds regime

Gurpreet Manku
Deputy Director General, BVCA

At Budget 2020, the Government announced that it would carry out a review of the UK funds regime, covering tax and relevant areas of regulation. The review rightly recognises that asset managers sit at the heart of the UK's financial services industry, supporting sectors from insurance to banking, channelling capital into productive investments and at the same time helping millions of individuals save and invest.

The UK's private equity and venture capital industry attracts significant flows of international capital into the UK, along with talented individuals from across the globe. The industry will support efforts across the UK to deliver growth in the COVID-19 economic recovery and support other public policy priorities, as evidenced by several case studies in our 'New Horizons' report.

The BVCA has put forward recommendations that enhance the UK's positioning as an attractive place to establish a private equity or venture capital firm and a leading funds domicile. There is a premium on jurisdictions where there can be this co-location of functions, i.e. where fund management businesses, funds and asset holding vehicles (where required) can all be based. The UK should be well placed (in some ways better placed than obvious competitors) to facilitate this and there are also clear economic and operational advantages to co-location.

In summary we stated:

- The **UK limited partnership regime (English and Scottish Limited Partnerships) is the legal bedrock of the UK private funds industry**, and the inspiration for numerous similar vehicles around the world. International investors are familiar with this regime and legal and tax enhancements to it can be implemented with relative ease, especially now that the UK is no longer bound by EU law. It is also important that the existing BEIS reform project is concluded as soon as possible and with only essential changes being made: stability and predictability in the existing regime is key, and the UK can still be a jurisdiction of choice for investors (particularly where an EU-based structure is not required). A clear and competitive UK Asset Holding Company regime will re-force the UK's positioning as a centre for co-location.
- The UK must remain a **competitive location for asset managers and individuals within these firms** to encourage capital to continue to be deployed in the UK and retain the country's positioning as a global investment hub. The full benefits of recent HMT initiatives, such as this review and work on asset holding companies, will only be realised if asset managers base themselves here as well.
- The UK **regulatory regime must also facilitate PE/VC fund managers' access to investors, transactions and talent**, whilst providing appropriate protections to investors. An excellent example of this is the work underway to enable DC pension schemes to invest into illiquid asset classes. Competition and change mean that the future of UK financial services regulation must be dynamic, especially in respect of regulation related to sustainability matters.

The detailed submission covers the areas listed on the next page.

UK limited partnership and Asset Holding Company regimes

BEIS consultation on LP reform	• A swift conclusion to BEIS' consideration of proposed reforms to UK limited partnership law is needed. The review was triggered by concerns that some UK limited partnerships (not PE/VC funds) were being used for anti-money laundering or other criminal purposes, and the implementation of EU's fourth Anti-Money Laundering Directive has addressed some of the issues related to Scottish Limited Partnerships. • The BVCA has been working with BEIS to address legitimate concerns about abuse and that has led to the development of some workable solutions that would meet any ongoing concerns.
Consistent treatment of PE/VC funds and portfolio companies	• We have proposed that the Government makes clear that, unless the contrary is clearly provided and policy considerations make it essential, any tax, legal and regulatory provisions should not treat PE/VC funds or fund managers as parent companies or parent undertakings, and that portfolio companies should not be treated as members of the same group as each other or otherwise associated for any relevant purpose. • Future legislation should take account of that general statement of principle. This would be helpful in providing certainty to asset managers on the UK's approach.
Option for separate legal personality	• It would improve the attractiveness of UK limited partnerships in the private fund sector if there was an option to establish a UK limited partnership either with or without a separate legal personality.
Amendments to Partnerships Accounts Regulation	• Under the Partnerships (Accounts) Regulations 2008 (as amended), accounts are required to be prepared and filed in respect of a UK limited partnership (in a similar way to companies) if the partnership is a "qualifying partnership". • These rules were introduced to implement EU Directive (90/605/EEC) and, at the time, it was clear from our discussions with officials that the UK Government was not convinced that there was a good policy reason to apply these EU rules to UK limited partnerships. Now that the UK is no longer a member of the EU, there is no obligation to retain these rules in order to comply with EU law.
Option for umbrella funds and compartments	• Private funds sometimes wish to establish "umbrella fund" structures under which separate "pools" of assets and liabilities (or "sub-funds") of a limited partnership are attributed to limited partners holding different classes of limited partnership interest. • We consider that this would be an attractive feature to introduce into UK limited partnership law so as to enable private funds structured as limited partnerships to operate as umbrella funds.
Removal of requirement for gazette notices for non-PFLPs	• Even though the UK now has a Private Funds Limited Partnership ("PFLP") regime which has modernised the reporting requirements for PFLPs, there are still many legacy limited partnership funds in existence. • The requirement to advertise changes in the London, Edinburgh or Belfast Gazette (as appropriate) is anachronistic and unnecessary. We consider that updated rules which align non-PFLPs with PFLPs would act as a simple yet effective way of reducing the administrative burden on non-PLFPS.

VAT and management fees	• VAT is a complicated and important area for our members, and we are keen to engage on the separate consultation on VAT later in the year.
Tax compliance and HMRC approach to the industry	• We have suggested a different regime for investment partnerships that are Collective Investment schemes could be considered as a way of reflecting their different nature and avoiding the administrative burdens that might be more relevant for trading partnerships. • In this context, we highlighted many examples of where the recent FA 2018 changes have significantly increased the burdens on and costs of reporting for investment partnerships for no obvious benefit for HMRC (the majority of limited partners are usually non-residents with no UK tax liability). • In respect of HMRC's approach to the industry, to attract foreign investment managers and their funds to the UK, it is crucial that they have confidence that the tax rules will be clearly enacted and explained and consistently applied.
Addressing trading vs investing risks	• We have covered three areas where the Government could give welcome reassurance to international investors in UK funds.
Stamp duty	• Secondary transactions in fund interests are increasingly common and the retention of the stamp duty charge for transfers of UK partnership interests creates complexity and difficulty in completion mechanics, and adversely differentiates UK limited partnerships from their competitors.

Attractive UK AHC regime	• For the UK Asset Holding Company ("AHC") regime to be successful it is absolutely crucial that the regime is better than competitor regimes/jurisdictions.
	• To be successful, the UK AHC needs to:
	    • have clear entry criteria. We suggest a minimum percentage ownership by funds which meet a diversity of ownership test or other qualifying investors;
	    • allow other investors (joint venture partners from outside the funds space) to participate in the AHC subject to the entry test still being met;
	    • offer a broad "participation exemption" for dividends and capital returns on equity;
	    • tax other profits (principally, yield on shareholder debt) on a margin basis that reflects the AHC's role;
	    • tax UK resident investors in the same way as they would be taxed if they participated in a competitor jurisdiction (e.g. a Luxembourg partnership with a Luxembourg AHC);
	    • be as straightforward to operate as possible; and
	    • avoid creating unnecessary risk of failure.

UK as a location for asset managers and individuals

CGT review and carried interest	• Follow on from our work on the OTS review of CGT, we have stated that any systematic overhauling of the UK taxation of capital gains, which does not recognise and reward entrepreneurship and investment risk (e.g. equalising the tax rates on gains with those on income), will undermine the case for investment at precisely the moment the economy needs its investors and entrepreneurs the most. • We explain why the BVCA believes that, so far as management equity and carried interest are concerned, the boundary between income and capital is conceptually drawn in the right place and its integrity is fully protected by existing rules. The UK has a comprehensive regime for the taxation of carried interest, which has been significantly refined over time (most recently in the Finance Act 2016) and as confirmed by the Government in two recent written replies to questions in the House of Lords, is in line with approaches currently taken by other G7 countries. The UK's competitive position as a fund management centre should not be further eroded by negative changes in this area.
Improved tax treatment of international workers	• The fund management industry (particularly in the PE/VC and other alternative asset spaces, but more generally too) is very internationally mobile. A number of jurisdictions have special tax regimes (commonly called "impatriate" regimes) designed to attract internationally mobile executives to work in them. • Overseas Workday Relief (or "OWDR") and, to a lesser extent, the remittance basis perform that function in the UK, but the overall UK regime is significantly less generous than the regimes offered by competitor jurisdictions.
Carried interest and the remittance basis	• In order to make the UK an attractive place for highly skilled, internationally mobile executives, the position for non-domiciled executives before the carried interest rules were changed in 2015 should be restored. Now that the remittance basis has been reformed (so that long-term UK residents have to pay to access the regime or lose its benefits completely after a period), the pressure to restrict the availability of the remittance basis to carried interest is significantly reduced. • Additional recommendations are made for non-domiciled investors.

UK regulatory regime

Our industry's central message is that the UK is home to a world leading PE/VC fund management industry, in part due to the world-class legal and regulatory standards that global institutional investors demand, and that these robust standards must be maintained as the cornerstone for the future of financial services in this country. At the same time, the UK cannot afford for its regulatory framework to become ossified, given the fierce competition between jurisdictions to attract PE/VC fund management activity and the host of political, environmental and societal challenges to which regulation must continually adapt in order to remain effective.

Supervisory efficiency and speed to market	• The UK can quickly boost the competitiveness of the UK business environment for PE/VC firms by improving operational processes and procedures at the FCA. We have suggested that the FCA aim to reduce current processing times for different types of authorisations/notifications relating to fund managers, funds and portfolio companies (the change of control regime). • Should the UK decide to move away from tracking current EU regulatory requirements, it could reduce or eliminate some filing requirements prescribed by EU law where it appears that the resulting materials are not in practice being used by EU or UK regulators. Examples include material change clearances under AIFMD (which could be eliminated or replaced by filings) and some AIFMD reporting requirements.
Approach to developing UK regulation	• Regulation developed for the traditional asset management sector will not always be appropriate for alternative asset managers (and vice versa). The two sectors have much in common but also many differences. Future regulatory requirements should be tailored accordingly and we have made recommendations in respect of the professional investor definition and the PRIIPs regulation. • The UK should also re-assess areas where it has gone further than EU legislation required ('gold plating'), or taken an implementation approach which makes compliance with the law as stated difficult.
Prudential rules for investment firms	• We have urged the FCA and the Government to revisit the regulatory classification and treatment of UK PE/VC MiFID adviser arrangers (classified as exempt CAD firms by the FCA), because EU Member States' approaches to similar firms put the UK at a competitive disadvantage (i.e. where similar activities are not licensed). • We remain concerned that there is a material risk of the UK applying the regime in a way which is more onerous than the EU/EEA and that is in practice more onerous than individual member States' application. This would be a very odd result in the context of Brexit.
Effective sustainability regulation	• The Government and the FCA must support and encourage the transition to a carbon-free economy by ensuring UK sustainability regulation for private markets investment is both proportionate and focusses on materiality, whilst remaining compatible with international frameworks including the evolving EU disclosure regime. • We have raised concerns about the EU's Sustainable Finance Disclosure Regulation with HMT and need clarity on the UK's approach to regulation covering sustainability-related financial disclosure (beyond the TCFD Roadmap).
DC pension and semi-professional investment in illiquid assets	• The largest obstacle for PE/VC funds trying to access UK DC pension schemes is the calculation method for the 0.75% charge cap applied to the default arrangements of DC pension schemes. This charge cap currently treats profit sharing models such as • We continue to stress that carried interest is better characterised as a profit share, rather than a performance fee, and that the best way of helping to improve outcomes for DC scheme members in this context would be for DWP to exclude it from the charge cap calculation (subject to appropriate conditions). • *Note: further detail is provided in a separate article in this Bulletin*

Monitoring competitiveness

Alternative Assets Competitiveness Unit	• A cross-departmental centre of excellence with a detailed understanding of the alternative assets sector should be established. Its mandate would be to ensure the UK retains its position as a competitive jurisdiction for our industry and can support firms to succeed on the global stage.

The BVCA is currently in dialogue with HMT about these recommendations and would like to thank all the technical committees for their input into this review.

02.

U.S. withholding tax on transfers of partnership interests

Matthew Saronson (Debevoise & Plimpton)
Veronika Polakova (Debevoise & Plimpton)

02. U.S. withholding tax on transfers of partnership interests

Matthew Saronson
Debevoise & Plimpton

Veronika Polakova
Debevoise & Plimpton

Background

A new U.S. withholding regime was introduced as part of the 2017 U.S. tax reform (the "Act") under section 1446(f) of the U.S. Internal Revenue Code. The U.S. Internal Revenue Service (the "IRS") has historically taken the position that a non-U.S. transferor of an interest in a partnership that is engaged in a U.S. trade or business is required to treat any gain from the sale of the interest as "income effectively connected with a U.S. trade or business" ("ECI Gain") to the same extent that the transferor would have been allocated ECI Gain had the partnership disposed of all of its assets at fair market value. The Act codified this position and imposed a new 10% withholding requirement on the "amount realized" on the sale of the partnership interest unless an exemption applies. As a further backstop to help ensure collection, the Act requires the partnership to withhold any amounts that the transferee failed to withhold, plus interest, from subsequent distributions to the transferee.

While the regime has now been in place for a couple of years, some uncertainty has remained regarding the details of its implementation. The IRS issued interim guidance in April 2018 in the form of Notice 2018-29 and proposed regulations in May 2019 (the "Proposed Regulations"), in each case to address some of this uncertainty and to establish exemptions from withholding. The IRS released final regulations in October 2020 (the "Final Regulations"), and as of January 29, 2021, the Final Regulations now generally apply to transfers of partnership interests. However, the partnership's secondary withholding obligation, a key component of the withholding regime, will not become effective until January 1, 2022. This article discusses highlights from the Final Regulations and provides some practical considerations for both sponsor and investors.

Application of the withholding regime

The Final Regulations include a presumption that withholding applies on the transfer of any partnership interest, unless the transferee obtains a certificate from the transferor or the partnership that establishes an exemption from withholding. This presumption means that the section 1446(f) withholding rules implicate transfers with no direct connection to the United States (e.g., transfers by non-U.S. parties of interests in non-U.S. partnerships that do not invest in the United States), which may be viewed by non-U.S. parties as an example of overreach by the U.S. government. Somewhat helpfully, the Final Regulations also provide that neither a transferee nor a partnership will be liable for failing to withhold if it can be established to the satisfaction of the IRS that the transferor had no ECI Gain on the transfer. Parties may find some comfort in the fact that failure to withhold thus does not mean per se liability (as was the case under the Proposed Regulations). However, given the practical difficulties that may arise in establishing to the satisfaction of the IRS that a transferor had no ECI Gain, transferees should still consider establishing a basis for an exemption rather than relying on persuading the IRS.

In addition to the applicability of the section 1446(f) withholding rules to secondary transfers of partnership interests, the IRS also clarified in the Final Regulations that the rules apply to so-called "disguised sales" of partnership interests, which may include a typical private equity subsequent closing adjustment. This result was a disappointment to many commentators who hoped the IRS would disapply the section 1446(f) withholding rules in this area given the complexity of the

"disguised sales" regime. In light of the position in the Final Regulations, partnerships should consider strategies to mitigate the risk of section 1446(f) withholding on subsequent closings—partnerships that generally do not expect to make ECI investments should consider providing a withholding exemption certificate described below to subsequent closing investors, whereas partnerships that expect to make ECI investments should consider alternative strategies, such as utilizing a subscription line prior to the final closing. Non-U.S. investors participating in early closings should seek to understand the partnership's subsequent closing process and seek assurances that they will not face withholding on a subsequent closing whereas all partners investing in a subsequent closing should seek confirmation that they do not need to withhold on their subsequent closing payment.

Establishing a withholding exemption

In order to benefit from an exemption from withholding under the Final Regulations, one of the seven certificates noted below will need to be provided by either the transferor or the partnership.

The following certificates may be provided by the transferor:

(1) Non-foreign status exemption

A transferor may provide a certificate that it is a U.S. person. An IRS Form W-9 is acceptable, and partnerships may simply use a valid Form W-9 held on file.

(2) Transferor's ECI share exemption

A transferor may provide a certificate stating that (i) the transferor has held its interest for the full three prior tax years, (ii) the sum of the transferor's and its related partners' allocable share of gross effectively connected income ("ECI") in each of those years was less than $1,000,000, (iii) the transferor's allocable share of gross ECI in each of those years is less than 10% of its total share of gross partnership income (as reflected on the transferor's Schedules K-1), and (iv) the transferor's share of ECI was timely reported on its tax return, and all U.S. taxes with respect to such ECI were paid. A transferor cannot provide such a certificate unless it has received a Schedule K-1 (or other required statement) reflecting distributable gross income for each of the prior three years. This requirement restricts the availability of this exemption as many non-U.S. partnerships without ECI do not routinely provide Schedule K-1s and it is not uncommon for private equity funds not to have distributable income in a given year.

(3) Treaty claim exemption

A transferor may provide a certificate that it is not subject to tax on any gain upon transfer of the partnership interest because of applicable tax treaty benefits that require a permanent establishment in the United States before business profits may be taxed. A transferor must include a valid tax form supporting the treaty claim. Utilizing this exemption will require particular attention to the activities of the underlying partnership since the IRS's position is that a U.S. office of the partnership satisfies the permanent establishment requirement under tax treaties. In contrast to the other exemptions, the transferee must mail a copy of the certificate to the IRS within 30 days after the date of transfer.

(4) No gain exemption

A transferor may provide a certificate that no gain will be realized by the transferor. In order to provide this certificate, the transferor would require the cooperation from the partnership as a supporting certificate from the partnership is required confirming to the transferor that certain types of ordinary income (i.e., "hot assets" attributable to a U.S. business) would not be recognized in connection with the transfer.

(5) Nonrecognition exemption

A transferor may provide a certificate that U.S. nonrecognition rules fully apply to the transfer.
The following certificates may be provided by the partnership:

(6) Partnership deemed sale exemption

The partnership may provide a certificate that if the partnership sold all of its assets on the determination date, either the partnership's net gain that would be ECI or the transferor's allocable share of the partnership's net gain that would be ECI would be less than 10% of partnership total net gain or the partner's allocable share of total net gain from such sale, as applicable. The determination date is generally the transfer date or any date within the 60-day period prior to the transfer date and, for certain transfers, the beginning of the taxable year.

(7) No U.S. trade or business exemption

The partnership may provide a certificate that it was not engaged in a U.S. trade or business during its tax year through the date of the transfer. This is a new exemption established by the Final Regulations and may be especially welcome for funds with a non-U.S. focus that are not engaged in a U.S. trade or business. The exemption may also be helpful for certain real estate, infrastructure and energy funds that make investments via blocker structures that are treated as U.S. real property holding companies. While these types of investments generally generate ECI under the Partnership Deemed Sale Exemption, they do not cause the funds to be engaged in a U.S. trade or business.

Determining amount to withhold

In the event that a withholding exemption cannot be established, the transferee will be required to determine the appropriate amount to withhold that is based on 10% of the "amount realized" by the transferor. "Amount realized" generally constitutes the consideration paid by the transferee and the transferor's share of partnership liabilities. If the transferee is not able to establish the amount of the transferor's share of partnership liabilities, then the transferee would be required to withhold the full consideration paid.

To avoid this undesirable result, the transferor may provide a certificate confirming its share of partnership liabilities as shown on its most recent Schedule K 1 (which may cover a tax year ending up to 22 months prior to transfer). Alternatively, for transferors who do not receive Schedule K-1s from a partnership, the partnership may provide a certificate detailing the amount of the transferor's share of partnership liabilities on the determination date.

The Final Regulations also include other mechanisms to reduce the required withholding amount in certain circumstances. In the event of a transfer by a non-U.S. partnership, it is possible to "look through" the transferring partnership and provide certifications for its U.S. partners and treaty-eligible non-U.S. partners, such that withholding would only apply on the "amount realized" allocated to the transferor's non-U.S. partners that are not eligible for treaty benefits. Alternatively, the transferor may provide a certificate as to the maximum tax liability it would have to pay on its transfer as of the determination date, which would allow the transferee to withhold this precise amount. In order to provide this certificate, the transferor would require the cooperation of the partnership as a supporting certificate from the partnership is required confirming the transferor's ECI Gain as of the determination date.

Practical implications

In light of the framework introduced by the Final Regulations, sponsors and investors should keep in mind the following practical implications:

- Sponsors should fine tune their transfer and subsequent closing procedures to ensure, to the extent possible, that 1446(f) withholding does not apply and that appropriate documentation supporting this position is obtained.
- Transferees should seek to obtain appropriate certificates establishing an exemption from withholding as well as contractual protection in their purchase agreements.
- Transferees may also wish to confirm that sponsors agree with their conclusion that an appropriate exemption from withholding was established to avoid the unpleasant surprise of withholding being imposed by the sponsor on their subsequent distributions.
- Investors who expect to transfer their partnership interests may consider requesting Schedule K-1s or utilizing a U.S. investing entity to hold their investment in order to be able to provide one of the transferor certificates in the future.

Conclusion

The Final Regulations establish a withholding regime with broad applicability that requires the transferor or the partnership to provide one of seven certificates to establish a clear exemption from withholding. However, as the partnership's secondary withholding obligation remains suspended for the remainder of 2021, it may be difficult for market practice to find an equilibrium. Transferors and transferees may struggle to convince partnerships to provide any certificates as partnerships have so far been reluctant to become closely involved with the implications of the 1446(f) withholding rules. Once the partnership's secondary withholding obligation is turned on starting in 2022, we expect partnerships to become active participants in the process and be more forthcoming with partnership certificates as it will be in their interest to establish a clear exemption from withholding.

03.

Funds DAC6 update: trends in reporting and compliance

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03. Funds DAC6 update: trends in reporting and compliance

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Introduction

In this article, we reflect on the events of the past six months in the area of DAC6 and discuss the trends in reporting and compliance. This has been a particularly turbulent period for investment fund sponsors when it comes to DAC6 compliance but, latterly, we have begun to see the market settle and sponsors' practices align as they plan for a future in which DAC6 will be part of the furniture for investment funds.

The story of the past six months begins with the conclusion of the Trade and Cooperation Agreement with the EU on 31 December 2020, just one month before the first DAC6 reports were due, when the UK unexpectedly announced that it would no longer be applying the majority of DAC6 hallmarks. Then, in January and February 2021, sponsors were faced with reporting deadlines for transactions stretching back to June 2018; however, following detailed analysis of a vast number of transactions, many sponsors found that their typical fund and investment structures were generally not reportable. Now, sponsors are getting used to DAC6 and beginning to incorporate it into their everyday tax compliance in a variety of practical ways. We will discuss each of these phases in turn.

A certain level of knowledge of DAC6 is assumed. For a general overview of DAC6, please see the BVCA Technical Bulletin of November 2019 and, for a discussion of certain DAC6 administrative issues, please see the BVCA Technical Bulletin of May 2020. In the BVCA Technical Bulletin of November 2020, we discussed investor negotiations and the main benefit test.

The UK diminishes DAC6

In accordance with the Trade and Cooperation Agreement with the EU, the UK decided not to apply most of DAC6. The UK's replacement regime, which has retrospective effect, only covers arrangements that would have fallen under Hallmark D, bringing the UK into line with the OECD's mandatory disclosure rules ("MDR"). Hallmark D covers arrangements designed to undermine reporting obligations or to obscure beneficial ownership. While, importantly, these arrangements are strictly reportable (so it is not relevant that, for example, a tax advantage may not have been sought), we only expect Hallmark D to apply to investment fund transactions in very limited circumstances.

For sponsors that mainly make portfolio investments in the UK and that use either UK- or offshore-established fund and investment structures, the UK's move from DAC6 to an MDR-style regime may result in a significant reduction in their compliance burden and reporting. However, for the many sponsors that regularly engage in cross-border transactions involving portfolio investments, structures and/or advisors that are in the EU, the full DAC6 regime will continue to apply via those EU jurisdictions and, accordingly, DAC6 will remain firmly on their compliance agendas. Indeed, many such sponsors have, unavoidably, found themselves having to, onerously, coordinate advisors in a number of jurisdictions and appoint a non-UK advisor to lead on DAC6 compliance.

It bears mentioning that MDR might not be the end of the story for the UK. HMRC may yet consult in relation to these new rules, so there remains some uncertainty over their final form. If a more complicated set of rules were to develop, this could ultimately add another layer of complexity for

firms caught between the UK's rules and DAC6. It should also be noted that the UK's similar disclosure of tax avoidance schemes or "DOTAS" rules will continue to apply to UK sponsors.

Trends in DAC6 reporting

Now that the deadlines have passed for reporting historical transactions, sponsors are reflecting on the types of transaction that were actually reported in the investments funds sphere following the significant analyses undertaken by many. Overall, the number of reports was lower than initially feared, but the following trends in reporting have been observed in the market:

- ***Luxembourg alphabet share structures reported in Germany***. A significant minority of German advisors and institutions have been taking a conservative view of common private equity structures, particularly the use of Luxembourg alphabet or tracking shares, which they consider "substantially standardised" (therefore falling under Hallmark A3) and satisfying the main benefit test. Consistent with the position in the BVCA Technical Bulletin of November 2020, we still consider this a very broad interpretation of this hallmark. In our view and experience, unless such shares are part of an unusual tax planning scheme or otherwise different from usual private equity structures, they should not generally be reportable (outside of Germany).
- ***Substantial reporting in Poland***. Among EU member states, Polish implementing legislation of DAC6 is notable for extending far beyond the scope of the Directive. Unlike DAC6, the Polish Mandatory Disclosure Rules ("Polish MDR") include in their scope purely domestic arrangements, additional hallmarks, indirect taxes, and can apply to non-EU resident taxpayers and intermediaries. In addition, Polish MDR provides for steep penalties in cases of non-compliance, including criminal sanctions. Therefore, it is unsurprising to hear that Polish advisors have filed a large number of reports to the Polish tax authorities on behalf of investment fund sponsors. Given the substantial reporting burden and administrative complexity involved in compliance with Polish MDR, sponsors have been relying heavily on local advisors to navigate the regime.
- ***More reporting than average across Scandinavia***. In Sweden, common management incentive plan structures have been habitually reported by advisors, and we have also heard, anecdotally, of sponsors having reports made on their behalf in Denmark and Finland. We understand that these trends in reporting generally originate from a conservative interpretation by local advisors of the main benefit test.

Trends in DAC6 compliance

While the market practice around going-forwards DAC6 compliance is still evolving, we have observed that sponsors are already significantly aligned in terms of their in-house compliance and investor relations.

a. Practical in-house compliance

Many sponsors that, following the UK's about-turn on DAC6, still have a significant EU exposure to DAC6, are implementing the following practical in-house measures:

- ***Adding DAC6 to a sponsor's internal 'compliance checklist' for every fundraising and investment transaction.*** As with FATCA and CRS, it is important to make DAC6 part of a sponsor's habitual tax compliance exercise in order to ensure that it is considered in every transaction and, also, to generate information that goes towards a sponsor's DAC6 compliance 'audit trail'.
- ***Having a DAC6 analysis in the tax structure paper for the transaction.*** By making DAC6 part of the tax structure paper (which is usually prepared by an external advisor), a sponsor ensures that DAC6 is dealt with contemporaneously with the tax structuring, thereby mitigating the risk of an 'unexpected' DAC6 reporting obligation surfacing immediately prior to a reporting deadline. It also gives the sponsor, together with any other parties to whom the tax structure paper is made available, a reliable and consistent DAC6 analysis that forms part of the written 'audit trail' demonstrating their DAC6 compliance.
    - We have observed that, in recent months, many third parties that are key to the investment funds industry (esp. banks and fund administrators) have begun to, as a matter of course, require DAC6 analyses in relation to the funds and investments on which they are engaged. Having a ready DAC6 analysis in the tax structure paper serves to reduce a sponsor's workload in complying with these requests.
- ***Dealing with DAC6 cooperation in engagement letters with external advisors***. Sponsors have quickly come to appreciate that external accounting, tax and legal advisors, with their often significant internal compliance functions and who are often, themselves, "intermediaries" for purposes of DAC6, are best-placed to efficiently analyse and coordinate this aspect of transactions. Sponsors are, therefore, requesting a combination of the following measures in their engagements (with increasing success):
    - That the advisor should supply the sponsor with the reference number and details of any DAC6 report filed with any tax authority on a transaction that is within the scope of the engagement.
    - That the advisor should initiate discussions with the sponsor as soon as it becomes aware that it (or the sponsor) may potentially need to report a transaction.
    - In a significant number of cases, especially where the advisor is routinely the advisor to a particular sponsor, that if a DAC6 analysis concludes that a report needs be made, the advisor will make the report. In these circumstances, advisors that are subject to privilege (and, therefore, generally exempt from reporting) have been asked to waive their privilege in order to make reports.
        - Without such a waiver in place, several sponsors have found themselves in the position whereby an ancillary services provider (such as a corporate services provider) has been the only non-privileged, EU-based "intermediary" on a transaction and has to evaluate whether it needs to report a transaction, or even that a sponsor's investment entity has had this responsibility directly (as a "relevant taxpayer"). Sponsors should try to avoid situations like this, where an intermediary that may not be close to the tax structuring is suddenly given primary responsibility for taking a view as to whether to make a report (or not), or a sponsor has to make a report themselves.
- ***Establishing mechanisms for tracking DAC6 on recent (and internal) matters***. In order to keep track of the information arriving via the compliance checklists, tax structure papers and external advisors' engagements (each a "source"), many sponsors have established the procedures set out below.
    - Maintaining a simple internal record of all matters, who the external advisors are and the information received from each source. For most sponsors, this is as simple as a spreadsheet maintained by the in-house tax or compliance function.

    - Having a regular, fortnightly or monthly, meeting between the internal 'record keeper(s)' and those internal team(s) that will generally be aware of the sponsor's latest transactions. Crucially, these kinds of meeting provide a forum to educate internal teams and identify and discuss arrangements in which external advisors were not involved, such as with repeat structures and internal incentive arrangement, where DAC6 reporting obligations may rest solely with the sponsor.

- ***Creating a DAC6 risk assessment and policy***. We recommend that sponsors commit to writing an assessment of their DAC6 risks and their resulting approach to DAC6 compliance. In addition to being a useful and practical reference point, it is something that a tax authority may refer to as part of an investigation or audit (on the basis of past experience with HMRC in relation to other tax compliance regimes) and is, increasingly, something that investors are asking to see or, at least, confirm to be in place. Furthermore, in many jurisdictions, reasonable policies and procedures, supported by a risk assessment, provide a defence to potential DAC6 penalties.

However, one issue with which sponsors appear to still be grappling is as to who should bear external advisors' costs in relation to DAC6 matters. Given that external advisors will often have their own DAC6 compliance obligations (as "intermediaries"), sponsors may argue that external advisors are, in many cases, merely discharging their own obligations and should therefore bear at least some of the cost. It is recommended that these issues are tackled expressly in an engagement letter, in order to give both sides certainty and comfort.

b. Investor relations: questionnaires and side letters

We have observed the market converge quickly on a reasonable, but sponsor-friendly, approach to interactions with investors regarding DAC6:

- ***A majority of investor interactions on DAC6 take the form of conversations and questionnaires***. Many investors have updated their tax DD questionnaires to refer to DAC6 and sponsors have often found that investors are interested in gaining 'soft comfort' that sponsors are taking a thoughtful and systematic approach to DAC6 compliance and that, by engaging with and reassuring investors on this front, requests for side letter protection and other 'hard comfort' can be headed off.
- ***Little variation in the scope of side letter protections***. To the extent that a DAC6 side letter provision is insisted upon by investors, sponsors have been comfortable committing to – and investors have tended to accept – providing a copy of any DAC6 report that it has filed by (and, for some sponsors, that has been filed on behalf of the sponsor and that it has in its possession), to any investor mentioned by name in the report. Whether or not a sponsor also gives side letter protection as to its DAC6 compliance tends to follow such sponsor's general policy on making representations as to compliance with law.

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This update has been prepared by members of the BVCA Taxation Committee and is provided on an information only basis. No responsibility can be accepted by the BVCA or contributors for action taken or not taken as a result of information contained in this article. Specific advice should always be taken in each situation.

04.

Access to DC pensions update

Tom Taylor (BVCA)

04. Access to DC pensions update

Tom Taylor
BVCA

Introduction

Pension funds are significant investors in private equity and venture capital funds. 38% of the £48bn[1] raised by BVCA member firms in 2019 came from pension funds worldwide. The relatively small proportion coming from UK pension funds (2%) was allocated by defined benefit ("DB") pension schemes. DB schemes are now largely closed to new joiners and most savers are investing for their retirement through defined contribution ("DC") schemes, and, in the UK, this pool of DC capital will only continue to grow, due to the prevalence of auto enrolment. As the future source of pension fund investment thus shifts from DB to DC schemes, the Government, regulators and other stakeholders (including the BVCA) have been discussing how to remove the barriers currently preventing DC schemes from allocating to PE/VC funds and other illiquid assets. Any removal of these barriers will not only benefit UK pension savers but also represents a potentially large new source of capital for investment via PE/VC funds into fast-growing UK companies.

Why DC schemes should be investing in PE/VC funds

One indication that DC pension scheme trustees' appetite for investment in PE/VC funds would be strong, were it not for various barriers, is that the asset class is very popular with investors around the world (North American DB schemes, in particular).

Reasons for this popularity include that PE/VC funds: offer risk-adjusted returns that, market-wide, have historically exceeded public market averages; grant access to private markets, which are expanding and offer exposure to fast-growing unlisted companies; and provide a long-term investment opportunity for investors with long term horizons, such as pension savers.

If there are clear benefits in allocating to PE/VC funds for investors generally, there is also a strong case that allocating to PE/VC would improve outcomes for DC scheme members specifically. Detailed modelling for a U.S. study suggests that by changing an asset allocation mix for a target date fund to include between 5 and 7% of private equity over a 45-year period, a DC scheme member contributing just over six thousand dollars a year to the target date fund could potentially increase the total amount saved and distributable in year 45 by approximately 8.7%, whilst not increasing risk. This positive analysis is mirrored by the positive perspectives of DC market participants on the potential of PE/VC funds to improve DC schemes' returns, as illustrated by the Mallowstreet and Partners Group report that features amongst the extensive research on the case for allocations to PE/VC funds by DC schemes, set out at the end of this article.

With such a solid case for DC schemes to invest in PE/VC funds, why are they not already doing so? The answer lies partly in the fact that DC schemes are subject to retail protection and liquidity considerations that distinguish them from typical LP investors. These considerations are connected to the structure of DC pension products, the market they operate in and the rules that govern how they are invested, and they create various barriers that are currently preventing DC schemes from accessing PE/VC funds. The BVCA is working in a number of areas to help change this.

[1] Industry Activity (bvca.co.uk)

Structural hurdles – the Productive Finance Working Group

Workplace DC default pension schemes have certain characteristics that make it more challenging to admit them to a traditional PE/VC fund than to admit DB pension schemes or other common types of LP. To an extent, these differences stem from the shift of financial risk and responsibility for an individual saver's longevity, from the employer to the employee/saver, that the broader transition from DB to DC entails. In theory, granting savers the responsibility for their own pension outcomes requires that those savers also be granted a greater degree of control. DC savers thus have more freedom than DB savers to monitor the performance of their scheme investments and move their pension between schemes if they so choose. This drives a focus on liquidity and gives DC schemes a more retail flavour, such that their fund investments will typically be in FCA-authorised fund vehicles.

For a PE/VC fund industry long centred around professional investors investing through unregulated fund vehicles, the world of authorised funds is an unfamiliar place, populated largely by open-ended funds and characterised by product-level (i.e. fund-level) regulations. These cover diversification, liquidity, pricing, leverage and a range of other fund design features that are not typically required (or at least not by regulators) in the context of institutional investment in illiquid assets like PE/VC funds, which typically use closed-ended fund models where the manager is regulated, rather than the product.

In this context, the BVCA has joined the Bank of England, HMT and FCA sponsored Productive Finance Working Group ("PFWG") which has been 'meeting' regularly during 2021 to identify solutions for increasing investment in illiquid assets such as PE/VC funds, in particular by DC pension schemes. A key objective of this group is to share thinking on potential rule changes to facilitate the launch of a new authorised fund vehicle by the end of 2021, based on the Investment Association's 2020 proposal for a Long-Term Asset Fund ("LTAF"). The FCA is an active participant in the PFWG and has been using the discussions to inform its ongoing consultation on the detail of the LTAF, which the BVCA is responding to in detail. The Department of Work and Pensions ("DWP") has an observer role in the PFWG.

The tax treatment of the LTAF was consulted on as part the review of the UK's funds regime by HMT. Both tax and the charge cap (see below) are not part of the remit of the PFWG. The BVCA provided feedback on the areas HMT work need to consider, dependent on the structure of the LTAF.

Our hope is that the LTAF may help create a bridge between the world of closed-ended, unregulated funds and that of open-ended, authorised funds by providing a suitable intermediary vehicle that can invest as an LP into traditional PE/VC fund structures. The PFWG report, to be completed in the summer, will also contain recommendations from various DC pensions industry players to address other cultural, operational and market barriers, such as the current tendency to focus on costs over returns, the fact that the technology used by the platforms (that host products for DC pension schemes) is geared for daily pricing, and a general lack of experience of investing in PE/VC funds and other illiquid assets and building them into a well-balanced portfolio of investments.

Pension investment rules – DWP's proposed changes to the charge cap

Irrespective of the work of the PFWG and the design of any new LTAF vehicle, challenges to DC schemes' access to PE/VC funds will likely remain as long as DC schemes are required to include carried interest when calculating whether the costs and charges attached to their investments are below the mandatory charge cap of 0.75% that DC schemes must apply. Fixed charges relating to different investments can be 'blended' within portfolios to accommodate any charges above 0.75% (for example a 2% management fee), to the extent these do not exceed the 'headroom' amount left by charges relating to a portfolio's other investments that are

below the cap. However, PE/VC funds with carried interest, the payment of which is unpredictable in timing, quantitatively unknowable in advance, and theoretically unlimited, present sufficient risk of a charge cap breach to prevent DC schemes from investing. This is compounded by competition between DC schemes that favours 'low-cost' products, which makes trustees extremely reluctant to consider investments that are perceived to be 'expensive' and likely to increase the overall fee burden, even if the cap would not be breached (and the returns could have been higher).

Despite this, the charge cap furthers the important policy aim, supported by industry and the BVCA, of protecting people's pension savings against being eroded by unwarranted or unnecessary fees. For unengaged DC pension savers, who join their workplace auto enrolment pension schemes by default and have little involvement or knowledge of their investments or what the scheme does with their savings, this is considered to be a real risk. The BVCA continues to make the case that carried interest arrangements are an inherently effective method of protecting investors that is consistent with the policy objective of the charge cap. PE/VC fund managers are typically only entitled to carried interest payments once they have returned investors' (in this case, DC scheme members') capital plus a preferred return. This aligns investors' long-term interests with those of PE/VC fund managers and leaves little scope for fund managers to profit in the event of poor or merely short-term performance.

The DWP now recognises, to a degree, that the charge cap calculation methodology causes problems for DC schemes that may be considering illiquid assets like PE/VC funds, and has consulted on proposals to address this issue. These include a multi-year 'smoothing mechanism' that would allow carried interest and performance fees to be spread across five years, and the removal of the current 'look through' approach for performance fees in venture capital and growth equity funds of funds (which would reduce the apparent cost of investing in funds of funds for the purposes of the charge cap calculation).

The BVCA's responses to these consultations, as well as explaining how carried interest already furthers the policy objective, pointed out that the proposed changes would not remove the risk of charge cap breaches entirely. At the same time, they would maintain the sector's focus on costs above overall returns and create perverse incentives for schemes to invest in particular structures or with managers predicting mediocre results, none of which would be in the interests of DC scheme savers.

As well as contributing to the PFWG workstream and responding to the FCA consultation on the LTAF vehicle, the BVCA continues to work through various government channels to put the case for carried interest to be excluded from the charge cap calculation altogether. In the long run, positive change in this area could open up an important new source of capital for investment via PE/VC funds.

Further detail on the case for PE/VC allocations by DC schemes

Summaries and links to further research and performance information supporting the case for facilitating DC investment in PE/VC funds is set out below. This has been provided to government in several of our submissions.

- A report by the British Business Bank and Oliver Wyman[2] in 2019 found that retirement savers in defined contribution pension schemes are missing out on higher returns from venture capital and growth equity. Retirement savings could be increased by 7-12% for a 22-year old, for example, if their DC pension scheme made 5% of investments in the UK's fastest growing and most innovative companies.

[2] The Future of DC Pensions: Enabling Access to Venture Capital and Growth Equity – British Business Bank (british-business-bank.co.uk)

- Academic research from Gregory Brown (UNC Kenan-Flagler Business School) and Steven Kaplan (University of Chicago Booth School of Business) in 2019[3] compared the annualised returns (internal rate of returns, IRRs6 and the Kaplan-Schoar (2005) public market equivalents ("PMEs") by vintage year of global buyout, venture, growth, and generalist private equity funds against the contemporaneous total returns of the MSCI All Country World Index. The returns have been higher than the MSCI and the PMEs are greater than one for every single vintage year.
- The annual BVCA Performance Measurement Survey[4] shows UK venture capital and private equity funds continue to demonstrate, on a since-inception basis, a high level of consistency in performance returns. Returns are net of all fees and costs, including carried interest.
- In its 2020 Public Pension Study[5], the American Investment Council examined the investments and returns of America's largest public pension funds (many of which invest in UK funds – overseas public pension plans are large investors in the BVCA data set above). Private equity was once again the best performing asset class for public pensions, delivering a median annualized return of 13.7 percent over a 10-year period. All returns are net of fees and carried interest.
- The Bain & Company Global Private Equity Report 2021[6] also showed that buyout funds have continued to outperform public equities (see figure 26).
- Research on risk in private equity carried out by Montana Capital Partners and the BVCA[7] has found that across a diversified portfolio of fund investments, the risk of losing capital can be brought down below 1%, and that levels of funding risk become predictable and manageable. In addition, the research also shows that for a suitably diversified portfolio of fund investments, the risk of an investment not being able to realise its valuation can be brought below 1%.
- Research from Mallowstreet in partnership with Partners Group[8] has pointed to a range of interesting conclusions relating to DC investment in private markets. The research found widespread belief amongst DC schemes and consultants that private assets can outperform listed equities over the long term by 1% to 3% p.a., with even higher expectations amongst larger schemes and master trusts. The research also suggested that trustees believe PE/VC fund investments can bring diversification benefits and that schemes would be prepared to hold private markets assets for long periods of time (four to five years for smaller DC schemes, much longer for most). Another conclusion was that intense market pressure to offer 'low cost' pensions will continue to encourage many DC trustees to avoid allocations that feature carried interest arrangements or performance fees.

[3] Have Private Equity Returns Really Declined? – Frank Hawkins Kenan Institute of Private Enterprise (unc.edu)
[4] Industry Performance (bvca.co.uk)
[5] What They Are Saying: Private Equity Delivers Robust Returns for Public Pension Beneficiaries – American Investment Council
[6] bain_report_2021-global-private-equity-report.pdf
[7] How risky is private equity? | BVCA | British Private Equity & Venture Capital Association
[8] Mallowstreet: UK DC pension schemes and private... (partnersgroup.com)

05.

TCFD mandatory climate-related disclosures:

an update and next steps for private equity and venture capital firms

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05. TCFD mandatory climate-related disclosures: an update and next steps for private equity and venture capital firms

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Introduction

In November 2020, the UK's Joint Regulator and Government Taskforce (the "Joint Taskforce") published a Roadmap setting out the planned timeline for the implementation of mandatory Taskforce on Climate-related Disclosures ("TCFD") aligned climate-related disclosures across a number of sectors. This article summarises the key developments to date and explains what is expected in the coming months. It also suggests next steps for private equity and venture capital firms ("PE/VC") as they prepare for implementation of the regime, which will affect UK-regulated firms and their UK-regulated investors.

An overview of the Taskforce on Climate-related Disclosures

The Taskforce on Climate-related Financial Disclosures was founded by the Financial Stability Board in December 2015 and consists of 31 members from across the G20. Its aim is to develop recommendations for effective climate-related disclosures to be used by businesses, investors and lenders. The purpose of these disclosures is to enable stakeholders to better understand climate-related financial risks.

The TCFD published a final report in 2017 which set out eleven disclosures centred upon four core pillars:

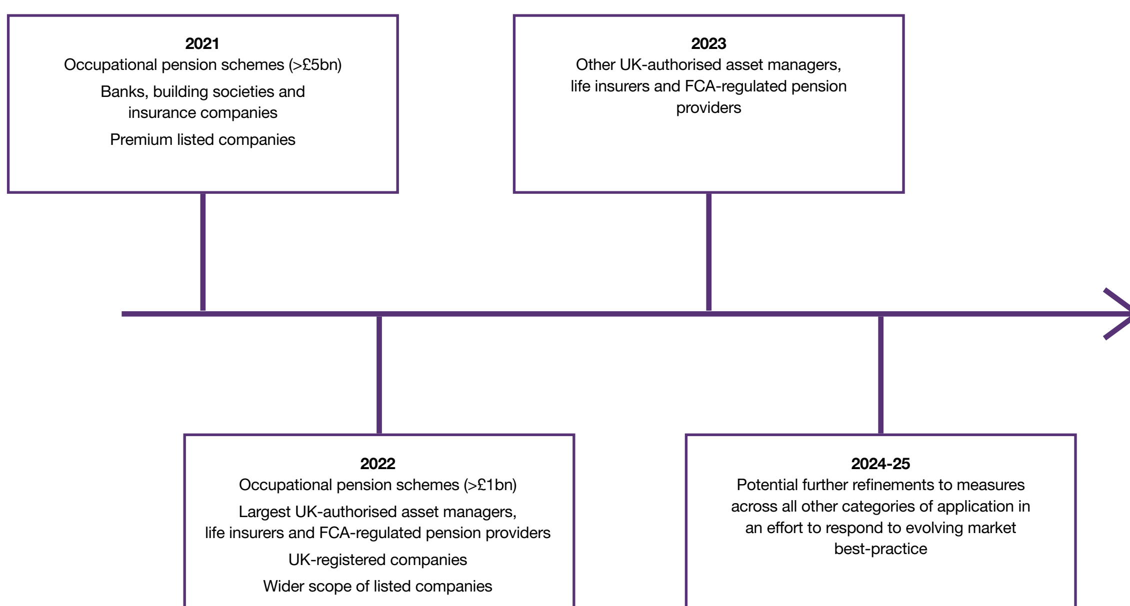
1. Governance – disclosures relating to an entity's governance around climate-related risks and opportunities.
2. Strategy – disclosure of the actual and potential impacts of climate-related risks and opportunities on the entity's strategy, business and financial planning.
3. Risk management – disclosure of the processes used by the entity to identify, assess and manage climate-related risks.
4. Metrics and targets – disclosure of the metrics and targets used to assess and manage climate-related risks and opportunities.

Fig I – Core elements of TCFD disclosures

In September 2017, the UK became one of the first countries to formally endorse the recommendations of the TCFD. The UK Government's 2019 Green Finance Strategy announced the creation of the Joint Taskforce (comprising the Financial Conduct Authority ("FCA"), Prudential Regulation Authority ("PRA") and the Pensions Regulator ("TPR")) as well as various Government departments (HM Treasury, the Department for Work and Pensions ("DWP") and the Department for Business, Energy and Industrial Strategy ("BEIS")). The Joint Taskforce's principal function was to develop a roadmap for the implementation of the recommendations of the TCFD in the UK.

The Joint Taskforce's November 2020 Roadmap set the UK on a path to implementation of TCFD reporting across most sectors of the economy by 2025 and, for many companies and asset managers, significantly earlier than that.

The UK's roadmap for the implementation of mandatory TCFD aligned disclosures



A sectoral overview of the various limbs of TCFD

The UK's implementation of the TCFD's recommendations is guided by a phased and sectoral approach. The following section is designed to provide a broad overview of the status and content of the proposals, rules and guidance relating to each sector outlined in the above timeline and the application of these proposals to PE/VC firms.

UK authorised asset managers

The FCA is yet to consult on the application of TCFD aligned disclosures to UK authorised asset managers (this category includes both MiFID investment firms providing portfolio management services and AIFMs, including small AIFMs with managing permissions).

In a letter sent by the FCA to the DWP in September 2020, the FCA announced its intention to consult on the implementation of these rules in the first half of 2021. The FCA's stated aim is to finalise the relevant rules by the end of 2021 with the new obligations coming into force for the "largest" UK authorised asset managers in 2022 and for all other UK authorised asset managers in 2023. We note that the FCA's intention is for the required disclosures to be directed towards clients and end-investors, rather than shareholders – meaning that the disclosures will cover the assets managed by the firm.

Importantly, while the Roadmap contemplates the application of mandatory TCFD aligned disclosures to the "largest" UK authorised asset managers in 2022, it is still unclear which UK authorised asset managers will fall into this category.

We expect the FCA consultation paper to cover the extent to which the content, structure, and format of the TCFD's original recommendations must be followed. The FCA is likely to require both entity level and product level disclosures from UK authorised asset managers. Managers will be particularly interested in the list of metrics which will be required and their ability to apply principles of proportionality.

Prior to UK authorised asset managers becoming directly subject to mandatory TCFD aligned disclosures in 2022/2023 they are also likely to be indirectly impacted by the proposals in other sectors as investors may increasingly ask for information from PE/VC firms to comply with their own TCFD related disclosure and reporting requirements.

Overlap between EU SFDR and TCFD

TCFD is focussed on climate risk and so is much narrower in scope than the EU's Sustainable Finance Disclosure Regulation ("SFDR"). Some investment management groups may need to make disclosures under both regimes. There may be some scope for using the same data to inform separate disclosures. For instance, managers which opt in to the principal adverse impact regime ("PAIs") under SFDR might collect scope 1, 2 and 3 Greenhouse Gas ("GHG") emissions data for this regime and TCFD. However, we expect the overlap between the two regimes to be imprecise, possibly resulting in multiple underlapping and overlapping disclosures.

UK occupational pension schemes

Mandatory TCFD reporting for UK occupational pension schemes will begin slightly earlier than for asset managers.

In a Consultation Paper issued in January 2021, the DWP set out proposals for the implementation of mandatory TCFD-aligned disclosures by UK occupational pension schemes[9]. The regulations are expected to be finalised over summer 2021. In summary, the regulations introduce new duties that will require UK occupational pension scheme trustees to put in place effective strategies, risk management and governance systems in relation to climate-related risks and opportunities. There will also be specific duties to carry out scenario analysis on the pension scheme's resilience to climate change, and to calculate metrics and targets to feed into the scheme's climate governance and decision-making. Schemes will be required to produce a publicly available TCFD report each year setting out details of their activities under the regulations. TPR will also have certain enforcement powers in the event of non-compliance.

[9] Personal pension scheme providers are regulated by the FCA and will therefore be subject to the FCA's regulatory timetable and measures. A separate regime is also expected to apply to UK public sector pension schemes but the details have not yet been announced.

As set out in the above timeline, these requirements will apply to the largest UK occupational pension schemes (i.e., those with assets of over £5 billion), plus authorised master trusts and collective defined contribution schemes, from 1 October 2021 (with the first pension scheme TCFD reports emerging from mid-2022). The proposals will apply to UK occupational pension schemes with assets of over £1 billion from 1 October 2022. The DWP proposes to review the regime in 2023-2024 and consider whether to extend it to smaller schemes.

These new duties for in-scope pension schemes are likely to have knock-on impacts for PE/VC firms in two main areas:

- **Large portfolio companies.** Where a portfolio company participates as an employer in an in-scope occupational pension scheme, PE/VC firms may see pension scheme trustees seeking greater information and data about climate-related risks, opportunities and resilience in the employer's business. This is especially likely where the pension scheme is a defined benefit scheme, since these issues are likely to be perceived as relevant to the employer's ongoing ability to support the scheme (the employer covenant).
- **Pension schemes as investors.** Where an in-scope pension scheme is an investor in a PE/VC firm, it is likely that it will increasingly seek information and data from funds and managers about the climate characteristics of the fund and its underlying investments as part of the scheme's data, metrics and targets compliance. In essence, this will create investor demand for new climate-related relevant data to flow up the investment chain to the pension scheme trustees as asset owner. Key items are likely to include:
    - the asset manager's internal arrangements for identifying, assessing and managing climate-related financial risks and opportunities;
    - Scope 1, Scope 2 and Scope 3 GHG emissions for the scheme's investment;
    - other data including emissions intensity and other factors relevant to the metrics the trustees must calculate and disclose;
    - information about how the asset manager adequately identifies, assesses and manages climate-related financial risks/opportunities in relation to underlying investments; and
    - verification in relation to information which underlying investee entities have provided and quality assurance of onward information provided upstream by the asset manager to the pension scheme trustees (or their consultants).

Although the legislation contains a useful proportionality easement in some key areas, there could still be some practical challenges here. Some managers may collect some scope 1-3 GHG emissions and other climate data where this overlaps with their own duties (for example PAIs 1 and 2 under EU SFDR). But, as noted above, the legal regimes are not completely aligned and so the data outputs may not exactly match the pension scheme's needs. Pension schemes will also be seeking data that is reported in relation to their holding as an investor, which may be different from aggregate data which a manager produces at fund or firm level.

Finally, pension scheme trustees are given a level of discretion under the legislation as to what data and metrics they use. Until investors' market practice becomes more settled in this area, managers could find themselves fielding requests for diverse datasets, with the resulting cost implications. It follows that managers will need to establish what it is, and is not, feasible for them to provide, and be able to explain this to pension scheme investors and their consultants.

Premium listed PE/VC firms

Premium listed UK asset managers are directly impacted by the introduction of TCFD. Following a consultation by the FCA in March 2020, a new Listing Rule was introduced which broadly requires UK premium listed companies to include a compliance statement in their annual financial reports, stating whether they have made disclosures consistent with the recommendations of the TCFD or provide an explanation if they have not made such disclosures.

This rule applies to accounting periods beginning on or after 1 January 2021 (and so the first annual reports subject to this new rule will likely be published in early 2022).

TCFD and portfolio companies

BEIS is currently consulting on proposals to require certain other UK companies and LLPs to make TCFD aligned disclosures. Detailed regulations are expected before the end of 2021 and to apply from 6 April 2022. The proposals will apply to accounting periods starting on or after 6 April 2022.
In summary, the proposals will apply to:

- all UK entities currently in-scope of the Non-Financial Reporting Directive (i.e. UK public interest entities);
- AIM companies with more than 500 employees; and
- all other unlisted UK registered companies and LLPs which are not captured by the above but have more than 500 employees and a turnover of more than £500m.

Under the proposals, in-scope entities will have to produce a TCFD report as part of the non-financial information in their Strategic Report or alternatively in the Streamlined Energy and Carbon Report (which forms part of an entity's Annual Report). The proposals will require in-scope entities to disclose climate-related financial information in line with the four pillars of the TCFD (governance, strategy, risk management and metrics and targets). However, BEIS has indicated that the proposals will not require the disclosure of climate-related financial information in line with the eleven more detailed TCFD recommendations.

If enacted, these proposals will partially replace the existing listing rules for premium listed companies. Such entities will be subject to mandatory reporting in relation to the four TCFD pillars (under the BEIS proposals) while also needing to comply with the existing Listing Rule (requiring disclosures in line with the eleven more detailed TCFD recommendations) on a comply or explain basis.

The proposed extension of TCFD aligned mandatory reporting to certain portfolio companies by BEIS will likely be helpful to PE/VC firms as it will assist in the establishment of a reporting chain. In scope portfolio entities will be required to collect certain information relating to metrics/targets that the PE/VC firm may themselves need to collate and publish, and pass upstream to investors (such as pension schemes as set out above).

However, we note that many UK portfolio companies will inevitably fall outside the scope of BEIS' proposals (i.e. unlisted UK companies/LLPs that either have fewer than 500 employees or a turnover of less than £500m). In such a case, investors may need to impose a contractual requirement to provide required information, especially when the PE/VC investor does not have control of the portfolio company.

Insurance companies, banks and building societies

The PRA has already taken action in relation to implementing mandatory TCFD aligned rules for banks, building societies and insurance companies. In April 2019, the Prudential Regulation Authority issued Supervisory Statement (SS3/19) and in July 2020, this guidance was supplemented by a further letter which set out the PRA's expectation that banks, building societies and insurance companies will have fully implemented and embedded their approaches to managing climate-related financial risks by the end of 2021.

What does this all mean for PE/VC firms?

While UK authorised asset managers await the publication of the FCA's consultation paper to see how mandatory TCFD aligned disclosures will directly impact them, there are a number of steps that PE/VC firms should consider taking in the interim. These include:

- undertaking an impact analysis to better understand the indirect and direct impact of the current proposals both on the PE/VC firm itself and on its portfolio;
- assess the availability of data and identify any gaps in that data that will likely be required to be provided to investor entities (such as certain UK pension schemes); and
- continue to monitor for the FCA's proposals on the implementation of mandatory climate-related TCFD aligned disclosures for UK authorised asset managers.

06.

The FCA's new Prudential Regime for Investment Firms

James Smethurst (Freshfields)

06. The FCA's new Prudential Regime for Investment Firms

James Smethurst
Freshfields

In April, the FCA published the second of its three Consultation Papers on the new prudential regime for investment firms. Firms affected include certain adviser arranger firms as well as collective portfolio management investment firms ("CPMI") carrying out certain MiFID investment services. The CP covers a number of important aspects of the new regime for UK investment firms, including the liquidity requirements applicable to firms, the individual capital adequacy and risk assessment ("ICARA") process and the remuneration rules. Several aspects of the FCA proposals go beyond the requirements of the equivalent European rules. It appears that the FCA has decided to exercise its post-Brexit freedom by increasing the regulatory requirements applicable to certain smaller UK firms.

Special K

The CP includes the FCA's proposals on certain of the K-factors which are most relevant to private equity and venture capital firms. The K-factors are used to calculate the capital requirements for investment firms that are not small non-interconnected firms ("SNIs"). These include a K-factor for 'assets under management' ("K-AUM"). Although K-AUM can include assets which are subject to an ongoing advisory arrangement, the CP helpfully clarifies this does not include the provision of advice on capital structure, industrial strategy and related matters, or advice and services relating to mergers and the acquisition of undertakings. Private equity and venture capital advisory arrangements where firms provide advice on buying and selling portfolio companies should therefore fall outside K-AUM.

Liquid launch

The new regime will also include a liquidity requirement. The FCA has decided that all firms should be subject to a basic liquidity requirement (the EU rules permit regulators to disapply liquidity requirements for SNI firms). For many firms this will be the first time they will be subject to an express requirement to hold a certain amount of liquid assets.

The FCA proposes that all investment firms will be subject to a basic liquidity requirement which is at least equal to one third of the firm's fixed overheads requirement (and 1.6% of any guarantees given to clients – if applicable). The fixed overheads requirement is calculated as one quarter of the firm's fixed costs. The basic liquidity requirement will therefore require firms to hold liquid assets equal to one month's fixed costs.

The basic liquidity requirement has to be met with core liquid assets, which include cash, short-term deposits with UK banks and money market instruments. Most private equity and venture capital firms will also be able to include trade receivables, although these can only be used to meet up to one third of the liquidity requirement and they will be subject to a 50 per cent. haircut.

ICARA

The ICARA process will form the main tool for the FCA to ensure investment firms have appropriate risk management standards, and will replace the current individual capital adequacy assessment

process ("ICAAP"). Many of the features of the ICARA process as similar to the current ICAAP. However, the FCA proposes that all firms will be required to follow the ICARA process, and so small firms which are not currently subject to ICAAP will have to comply with the ICARA process. The EU rules do not apply the equivalent of the ICARA to SNIs unless the relevant regulator decides they should apply.

The rules will require all investment firms to meet a new Overall Financial Adequacy Rule ("OFAR"). To meet the FCA's Threshold Conditions for authorisation, a firm must satisfy the OFAR. The amount of capital required to meet the OFAR will be called the 'own funds threshold requirement'; while the amount of liquid assets needed to meet the OFAR will be called the 'liquid assets threshold requirement'.

To meet the OFAR a firm must hold adequate capital and liquid assets to:

- **i.** ensure it can remain viable through the economic cycle, with the ability to address any potential harm from its ongoing activities; and
- **ii.** allow it to wind down its business in an orderly way.

To determine the financial resources needed to meet the OFAR, a firm will have to undertake the ICARA process at least annually, which will involve the firm:

- **i.** identifying and monitoring the harms that are relevant to the firm;
- **ii.** undertaking harm mitigation;
- **iii.** undertaking business model assessment, planning and forecasting;
- **iv.** undertaking recovery action planning;
- **v.** undertaking wind-down planning; and
- **vi.** assessing the adequacy of own funds and liquidity requirements.

The amount of capital and liquid assets the firm needs to hold will be the outcome of this analysis. For example, if the firm identifies that it faces certain harms which cannot be fully mitigated by non-financial systems and controls then it will have to hold capital or liquid assets to address those harms. Similarly, if the firm's business model assessment indicates that it is vulnerable to certain stressed economic circumstances then it will have to consider whether it needs to hold additional capital or liquid resources to address this risk. The ICARA process will have to be documented and firms will need to keep these documents for at least 3 years.

Although in theory a firm may conclude that the amount of capital and liquid assets it is required to hold as a result of the basic requirements (e.g., the fixed overhead requirement or K-factors) is sufficient to meet the OFAR, the likelihood is that the result of the ICARA process will indicate firms need to hold more capital and/or liquid assets to meet the OFAR.

The FCA is very clear that it expects a firm's senior management to be involved in the development and oversight of the ICARA process. In particular, the governing body of the firm must review and approve the ICARA document.

Firms will have to report the key information from their ICARA process to the FCA in a new ICARA Questionnaire. The FCA will undertake a Supervisory Review and Evaluation Process ("SREP"), which could result in the FCA determining that the firm needs to hold more capital or liquid assets to meet its OFAR. However, for most firms the FCA intends that the SREP will be 'harm-led' rather than a regular review of each firm's ICARA. In other words, the FCA will look at various data it receives to determine whether the particular harm presented by the firm (or possibly type of firm) requires a SREP.

The FCA is also proposing to introduce a series of formal intervention points. For example, if a firm's capital falls below 110 per cent. of its own funds threshold requirement then it must notify the FCA, which will be an early warning to the FCA that the firm is in financial difficulty and the FCA will monitor the firm and decide whether intervention is required such as blocking distributions or triggering the firm's recovery actions, if a firm falls below 100 per cent. of its own funds or liquid assets threshold requirements then the FCA will expect the firm to have triggered all of its recovery actions and the FCA may intervene for example, by requesting support from the firm's parent company or placing restrictions on the activities the firm can undertake.

Remuneration

Remuneration will be one of the most important areas for firms. The EU rules disapply the remuneration rules to SNIs. The FCA is proposing to apply remuneration rules to all investment firms, although SNIs will only be subject to the higher level rules rather than the more prescriptive requirements.

Very broadly, SNI firms will have to have a remuneration policy which must be subject to the review and oversight of the firm's governing body. The policy must distinguish between fixed and variable remuneration and ensure there is an appropriate balance between the two components. The objective of the policy must be consistent with, and promote, sound and effective risk management by aligning the risk and reward of staff. To do this the policy will have to reflect the firm's risk appetite and strategy including with regard to environmental, social and governance risk factors, and must also extend to the firm's culture and values.
Non-SNI firms will also be required to have a remuneration policy. But they will also need to comply with more prescriptive remuneration requirements. These include the requirement to set a ratio between fixed and variable remuneration as well as the ability to adjust variable remuneration for employees who are 'material risk takers' through in-year adjustments, malus and/or claw-back arrangements. These would apply where the employee's conduct resulted in losses to the firm or fell below the appropriate standards of fitness and propriety.

The very largest non-SNI firms will also be required to establish a remuneration committee and must defer a certain proportion of variable remuneration and ensure that it is paid in equity-like instruments.
The FCA states clearly that it considers carried interest to constitute variable remuneration. However, it is less clear how some of the specific rules (particularly those requiring in-year adjustments, malus or clawback) will apply to carried interest in practice.

Conclusion

The second of the FCA's consultation papers covers a number of important areas which firms will need to review in order to assess the impact on their current arrangements and practices. The fact that the FCA has decided to apply aspects of the regime to all investment firms (albeit to varying degrees) will inevitably increase the regulatory burden particularly on the smallest firms. This may lead some firms to question whether they really need to be investment firms at all.

07.

Corporate Governance and Audit Reform

Ciaran Harris (BVCA)

07. Corporate Governance and Audit Reform

Ciaran Harris
BVCA

In March 2021 the Department for Business, Energy and Industrial Strategy ("BEIS") published its long-anticipated consultation titled 'Restoring trust in audit and corporate governance'. The consultation document aims to implement most of the recommendations of the Kingman, Brydon and CMA reports into the audit profession, the role of the regulator and corporate reporting and audits, including expanding the definition of a 'public interest entity' to cover large private companies. The reform aims to create new powers to hold directors of large companies to account and establish a new audit regulator backed by legislation that has much stronger powers to enforce standards. The key aspects of the consultation that will impact the private equity and venture capital industry are summarised below.

Summary of key recommendations

The consultation paper covers a range of areas and the key areas the BVCA is currently reviewing are:

- Expanding the definition of a "Public Interest Entity" ("PIE") to include large non-listed companies. A company that is a PIE would have additional reporting and audit requirements, while directors would be subject to new responsibilities. The inclusion of large private companies in the PIE definition would result in the need to comply with prior regulations a PIE must adhere to, as well as the proposed rules outlined here. In summary, the previous requirements cover the audit process, including auditor rotation and prohibitions and limits on non-audit services.
- New directors' duties relating to internal controls and risk management in a way that builds upon the UK's existing framework. the Government's initial suggested option is less burdensome than the US Sarbanes-Oxley system.
- New powers to hold directors of large companies to account in relation to their reporting and audit obligations.

Further information on the areas the BVCA is monitoring

Definition of a Public Interest Entity

The consultation specifies two options under this recommendation, with both relying on turnover and/or balance sheet metrics.

- Option 1 (an estimated 1,960 companies would be brought into scope). This option will adopt the test used for large companies required to include at corporate governance statement in the directors' report. All companies with more than 2000 employees **or** a turnover of more than £200m and a balance sheet of more than £2bn.
- Option 2 (an estimated 1,060 companies would be brought into scope). This option utilises the threshold for the non-financial reporting requirements for existing PIEs. Large companies with over 500 employees **and** a turnover of more than £500m would be considered a PIE.

Many of the proposals set out in the consultation relating to audit, corporate reporting and corporate governance are focussed on PIEs. The Government recognises that any changes to the PIE definition would need to be introduced at an appropriate pace to provide companies with the time they need to prepare. To achieve this, the Government envisages a significant lead time before introducing a new PIE definition. Alternative Investment Market quoted companies with a market cap above €200m will also be included in the definition of a PIE, with up to 105 companies being brought into scope.

Directors' Duties and Internal Controls

The consultation sets out three options for strengthening the UK's internal controls framework. They are not mutually exclusive, and more than one is likely to be imposed.

a. The first option set out in the consultation would see the CEO and CFO, or the board collectively, required to carry out a review of the effectiveness of internal controls each year and make a statement as part of the annual report, disclose the benchmark system (if any) and explain how they have assured themselves that it is appropriate to make the statement. If there are deficiencies, remedial action will be required along with a stated timeframe for the stated actions. This is the Government's preferred option and could be implemented via changes to the UK corporate governance code or legislation. It would essentially entail a strengthening of the existing UK framework.

b. The second proposed option would see the auditor required to state, in the audit report, more information about the work required to understand the company's internal controls, how effective these are and how that work has influenced the audit. This will not be a formal audit opinion on the internal controls' effectiveness and would place an explicit duty on the board to disclose to the auditor and audit committee any significant internal control deficiencies or weaknesses.

c. The final option would work in tandem with the first and would require the auditor to provide a formal opinion on the directors' annual attestation about the effectiveness of internal controls. It would match the scope of the directors' statement. This option will mandate auditors to perform additional work and express an opinion, potentially limited to key internal controls over financial reporting, or a sub-set of that.

A graduated approach will most likely apply with requirements to premium listed companies in the first instance, followed by other PIEs two years later.

Dividends and capital management

The consultation sets out three issues with the current framework that will be addressed; there is no fixed definition of realised profits and losses; there are concerns about transparency; and the law's focus on capital maintenance, realised profits and distributable reserves is backward looking.

The Government intends to provide the Audit, Reporting and Governance Authority ("ARGA") (the successor to the Financial Reporting Council ("FRC")) with the responsibility for defining realised profits and losses by either giving it a duty to prepare guidance or powers to make binding rules. This would enhance the legal status and enforceability of the definitions. A full consultation from first principles is expected before finalising the rules and/or guidance.

Companies will be required to disclose their distributable reserves in their annual report, which must be greater than the proposed dividend. Where this is impossible to calculate the company will report a "not less than" figure. If there are subsidiaries involved, the parent company will be required to estimate and disclosure

the amount of potential distributable profits across the group that could be passed up to the parent. Views are invited on giving ARGA powers on how to calculate these amounts and guidance will be published to assist the proposals.

A new directors' statement, confirming that the directors have satisfied themselves that the dividend is within distributable reserves, have given regard to s172 of the Companies Act 20006 and that it is their expectation that the dividend payment will not threaten the solvency of the company over the next two years, is also being proposed.

Increased obligations in relation to fraud

The Government is proposing that directors of PIEs be required to report on the steps they have taken to prevent and detect material fraud. The Government believes this will reinforce directors' primary responsibility for fraud prevention and detection and may, in some cases, enhance the focus on the risks relating to fraudulent financial reporting. The Government will discuss with the FRC and other interested parties the need for supporting guidance.

The Government will legislate for this as well as the proposed requirement that auditors of PIEs, as part of their statutory audit, report on the work they have performed to conclude whether the proposed directors' statement is accurate. This would give auditors a responsibility to consider relevant directors' conduct.

Finally, a review of the use of the principle "true and fair view" is proposed alongside the development of a new user guide on audit. These proposals have been brought forward by the FRC.

New regulatory regime for directors

It is proposed that ARGA will be given powers to investigate and sanction breaches of corporate reporting and audit related responsibilities by PIE directors. It will have the ability to take civil enforcement action against all PIE directors (and not just accountants) and would defer cases to the Insolvency Service. ARGA will carry out the standard-setting, supervision, monitoring and enforcement activities to ensure high standards of audit and corporate reporting. This regime will not replace existing arrangements for taking action against directors, such as the FCA Listing and Transparency Rules.

Powers will apply to enforcement of existing duties which include keeping adequate accounts, approving and signing accounts only if they give a true and fair view, providing a statement as to disclosure to auditors and providing information or explanations at the request of the auditor. ARGA will be given the power to change these duties when it deems changes are needed. The powers will be complemented by including provisions in remuneration arrangements that allow clawback or withholding of remuneration (malus), with a minimum period of application of at least two years after an award is made.

In light of the current challenges to the UK economy, the consultation period is running over a longer than normal period until 8 July. Subject to the outcomes of the consultation, the Government will bring forward primary legislation to take forward the proposed reforms when parliamentary time allows, while the FRC will begin to transition to ARGA.

08.

National Security and Investment Bill

Amy Mahon (Simpson Thacher & Bartlett)

08. National Security and Investment Bill

Amy Mahon
Simpson Thacher & Bartlett

The National Security and Investment Act 2021 (the "NSI Act") received Royal Assent on 29 April 2021 and is expected to come into force later this year.

The NSI Act gives the Secretary of State for the Department of Business, Energy & Industrial Strategy ("BEIS") the power to review a transaction and make an order preventing, remedying or mitigating a national security risk. There is a new Investment Security Unit within BEIS that will review transactions. The NSI Act introduces a mandatory notification regime for trigger events involving acquisitions in 17 specific sectors (the "Mandatory Sectors") (including advanced robotics, artificial intelligence, communications, computing hardware, data infrastructure and energy – to name but a few). Failure to notify such a transaction in a Mandatory Sector renders the transaction void. In addition, there is a voluntary regime whereby parties can seek clearance of a transaction which is not subject to mandatory notification but which could give rise to national security concerns.

The trigger event is the acquisition of material influence over a qualifying business or the acquisition of a 25% stake or more than 50% or 75% of such a business.

Once a transaction has been notified, BEIS has up to 30 working days to determine whether to call-in an acquisition for further assessment or ask for further information or to take no further action in which case the transaction is cleared. This period may be extended by a further 45 working days. If an acquisition is called-in, then conditions could be imposed or in extreme cases the investment may be blocked. BEIS can exercise its call-in power for 5 years following an acquisition (provided it is within 6 months of becoming aware of the transaction). Failure to comply with the regime, including failure to make a mandatory notification, can result in civil and criminal sanctions – including fines of up to 5% of global turnover or £10m (whichever is greater) or imprisonment for up to 5 years.

The BVCA has engaged with BEIS on this Bill since its early inception – having responded to the consultations in the 2017 Green Paper, the 2018 White Paper and the consultation on the sectors in scope of the mandatory regime, as well as engaging in other correspondence and meetings with BEIS and engaging with members of the House of Lords. While the BVCA is supportive of measures for the purpose of protecting national security, our concerns were to ensure there was clarity on the law and that any regime was proportionate, focused on national security and did not act as a disincentive to investment in innovation or infrastructure. The BVCA was keen to ensure that its venture capital members were not faced with the cost and time delay of mandatory notifications of transactions that would technically be in scope (due to the very wide definitions proposed in the Mandatory Sectors) despite being very low risk from a national security perspective. As such narrowing certain technology definitions of the Mandatory Sectors was critical.

A number of our recommendations were ultimately reflected in the Act. For example, we advocated using the test of "material influence" (being the widely understood test under the Enterprise Act 2002) rather than the test of "significant control" under the newer and complex PSC regime, which is focussed on beneficial ownership as much as actual influence. In addition, the trigger event for mandatory notification was increased from 15% (at the draft Bill stage) to 25%. A number of our suggested amendments to the Mandatory Sectors and the inclusion of materiality thresholds within those definitions were included (such as public communications business with a turnover of less than £50m). Sub-contractors were removed from the scope of "Critical Suppliers to Government Sector" – their inclusion would have imposed a significant due diligence burden. The definition of data infrastructure was refined to limit it to the provision

of data infrastructure to critical sectors only and to make clear that the provision of security services or ownership of the site on which a data centre is located would not be captured by the definition. Certain categories of commoditised products or services were removed from certain Mandatory Sectors.

We also stressed the importance of informal guidance, particularly in the early years of the regime, to assist market participants in determining whether their transaction was in scope of mandatory regime or whether it was likely to be of concern thereby meriting notification under the voluntary regime. BEIS offers such informal guidance which will be very helpful to BVCA members.

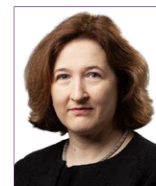
We have also advocated the introduction of secondary legislation, in due course, to exempt certain transactions from scope – such as trigger events involving an acquisition by an entity controlled by a regulated fund manager or transactions that have been approved by other sector regulators (e.g., OFGEM or OFCOM) or involving businesses that have been vetted and received funding from UK Government sources. We will continue this engagement with BEIS on the processes as well as guidance issued by the Government relating to this new regime, and keep our members updated.

09.

The Pensions Regulator: approach to new criminal offences

Camilla Barry (Macfarlanes)

09. The Pensions Regulator: approach to new criminal offences



Camilla Barry
Macfarlanes

The Pension Schemes Act 2021 received Royal Assent on 11 February 2021. Amongst many other provisions designed to strengthen the Pensions Regulator's ability to supervise occupational pension schemes, it introduces two new criminal offences of "avoiding an employer debt" and "conduct risking accrued scheme benefits". Despite representations from the BVCA and many others particularly in the pensions industry, these provisions passed into legislation in the form originally put forward in January 2020. None of the amendments proposed to clarify the offences were adopted. The provisions are not in force but are expected to be brought into force in the autumn. They do not have retrospective effect.

The result is that the new criminal offences are, in the view of many, unclear and could criminalise normal commercial activity. This is not the stated intention of government, which is instead only to criminalise the most serious conduct which intentionally or recklessly harms pension scheme benefits or, in the words of Therese Coffey, Secretary of State for Work and Pensions, to "tackle those who try to plunder the pension pots of hard-working employees" by ensuring "prison for pension pot pinchers".

To bridge the gap between the policy intent and the concerns caused by the broad language of the Act, the Pensions Regulator has consulted on its approach to the investigation and prosecution of the new criminal offences. The BVCA has responded.

Prosecutions may be brought by Pensions Regulator, the Secretary of State for Work and Pensions or the Director of Public Prosecutions. The Pensions Regulator's consultation relates only to its own approach.

As a reminder, the new criminal offences are:

- avoidance of an employer debt. This offence can be committed by any person who intentionally and without reasonable excuse is a party to an act, failure to act or course of conduct that prevents the recovery of an employer's statutory debt payable to a pension scheme or prevents it falling due or compromises or reduces the amount otherwise due. The offence is punishable by up to 7 years' imprisonment and an unlimited fine.
- conduct risking accrued scheme benefits. This offence can also be committed by any person, whether or not associated with the scheme or its sponsor, who without reasonable excuse engages in a course of conduct that he knew or ought to have known would detrimentally affect in a material way the likelihood of accrued benefits being received. The offence is also punishable by up to 7 years' imprisonment and an unlimited fine.

As an alternative to a criminal sanction, a civil penalty of up to £1 million may be imposed.

The concern arises from the fact the enforcement of debt or of a contract or any grant of security for a debt by an employer sponsoring a defined benefit pension scheme or any other transaction or action that is detrimental to the financial standing of such employer or its assets may be detrimental to the pension scheme. As such, unless the person has a reasonable excuse for their actions, on the face of the legislation, a criminal offence may be committed. The offence may be committed by any person whether or not connected to the employer and whether or not they have any relationship or obligation to the pension scheme.

The Regulator's draft guidance clarifies that:

- it will interpret "intent" for the purpose of the offence as avoidance of an employer debt as having such avoidance as one of the main purposes of the transaction;
- it will adopt the same approach to assessing material detriment for conduct risking accrued scheme benefits as for its similar powers to impose contribution notices;
- advisors who are not parties to any transaction may have secondary liability for aiding, abetting, counselling or procuring the transaction;
- it is for the prosecution to demonstrate that a person has no reasonable excuse but the defendant must first put forward an explanation for their conduct and provide sufficient evidence from contemporaneous records to establish a reasonable excuse;
- in assessing reasonable excuse and whether to prosecute, the degree of communication and consultation with trustees will be relevant;
- it will use three main criteria for determining whether a person has a reasonable excuse:
    - Whether the impact on the pension scheme was incidental or a fundamentally necessary step to achieving the person's purpose.
    - Whether there was adequate mitigation to offset any impact on the pension scheme.
    - Whether there was a viable alternative which would have avoided or reduced the impact on the scheme.

The draft guidance provides some examples. For instance, no prosecution would be expected where an employer raises debt which has prior ranking security than the pension scheme, or with higher interest rates payable than conventional debt if the debt is essential for the survival of the business and there is no alternative other than insolvency. Also, no prosecution would be expected if an employer faces a liquidity crisis and approaches its lending syndicate, but the lending syndicate refuse to lend further money, triggering an insolvency process. The draft guidance states that the Regulator would not expect the lender to continue lending if it were materially against their interest to do so.

The BVCA has responded to the consultation calling for a joint approach by the three prosecuting authorities and clearer principles and better analysis of examples to provide more precise guidance as to what will constitute a reasonable excuse. The BVCA highlighted that responsible individuals will not wish to take any action that could potentially be criminal and that very clear rules and principles are required to define the conduct that is criminal.

10.

Corporate Transparency and Companies House reforms

Victoria Sigeti (Freshfields)
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10. Corporate Transparency and Companies House reforms

Corporate Transparency and Register Reform: powers of the registrar

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As part of the government's response to the Corporate Transparency and Register Reform Consultation, which was published in September 2020, it proposed that Companies House would have new powers to query information provided to it.

This Consultation explored how those powers might be framed in a range of areas. It also covered certain matters relating to the reframing of the Registrar's administrative removal powers, digital filings and changes to the regime relating to the obligation on companies to keep certain registers.

The proposals included the introduction of a discretionary power for the Registrar to query and check information before it is placed on the register, as well as an extension of the Registrar's powers to amend and/or remove information that is already on the register.

The BVCA was supportive of many of the proposals outlined in the Consultation. However, in our response, we outlined two principal areas of concern.[10]

The first of these related to the scope of the querying power. The Consultation proposed that the querying power should be broadly framed and could be used by the Registrar if information appears fraudulent, suspicious or might impact significantly on the integrity of the register and the UK's business environment. These factors would be reviewed on a case by case basis on a risk based approach. This would mean that queries could be raised even in the absence of other intelligence (one example given in the Consultation is where a company is set up with high share capital, which is relatively common in private equity and venture capital transactions). The BVCA was concerned about this ability to query information in the absence of other intelligence as we believed that it could create material uncertainty for companies about whether or not filings would be accepted and about what type of evidence might need to be provided.

The second related to the proposal that the Registrar should have the power to remove director appointment filings from the register, notwithstanding the fact that the removal of filings which have legal effect upon registration will otherwise be left to the courts as is the case today. The BVCA was concerned that this proposal could create legal uncertainty in relation to the validity of actions taken by a director both pre- and post-removal of the filing and could lead to an increase in the number of de facto directors who rely on ostensible authority.

The BVCA will continue to engage with BEIS to assist with the further development of these proposals.

Corporate transparency and register reform: implementing the ban on corporate directors

Overall, the proposed "principles" based exception approach to the ban on corporate directors accommodates the legitimate use of corporate directors while maintaining a flexible and manageable framework for companies. However, there are certain issues that should be addressed. Furthermore, it is not appropriate to apply the regime to LLPs and LPs.

[10] BVCA response to Powers of the Registrar Consultation

The goal of deterring illicit financial flows through corporate opacity is justifiable. As with any such change, the new regime will necessitate compliance costs and an administrative burden on companies to achieve familiarisation with the rules, analysis of group structures, the replacement of corporate directors and the appointment of suitable natural persons. Given the complexity of the rules a longer timeframe for facilitate compliance would likely result in a more thorough and considered approach from stakeholders.

The "all reasonable steps" standard being taken by Company C to verify Company D's directorship is subjective. Company C's actions could range from checking public records to requesting confirmations from Company D. The PSC regime's twin obligation standard could be emulated so that Company D's directors also have an obligation to confirm compliance with the rules. Guidance as to what "all reasonable steps" means should take into account overseas entities that may act as corporate directors.

Companies are trending toward selection of natural persons as directors having already begun to harmonise their approach with jurisdictions where corporate directorships are barred. There is also an increased focus on director's training, compliance with duties and appropriate selection.

If LPs and LLPs are prohibited from corporate directorships this could create inconsistencies in the regime if applied to overseas entities given the diversity of standards applied across jurisdictions to what are otherwise similarly treated entity types (e.g. Delaware and Scottish LPs have legal personality but English LPs do not). If partnership structures are exempt, this should be based on specific characteristics of the qualifying entities, such as legal personality and reporting obligations rather than solely specifying entity types. If it were applied, the principal of natural person directors should apply to LLP designated members or members responsible for management. It is unusual for LPs to be appointed as corporate directors but if this occurred then looking to the general partner would be the effective means of identifying the effective corporate director as the natural person principle could apply to the general partner's members.

Applying the proposed Corporate Director principles to LLPs would not be appropriate in practice. LLP members do not owe the same statutory duties to LLPs as directors do to companies. Arguably, designated members share more duties in common with company secretaries. Generally, LLP members are more akin to shareholders then directors so extending the prohibition to LLP members would be the equivalent of preventing corporate ownership in a company. Finally, LLPs may allocate director-like responsibilities to non-members. Such changes would require significant overhaul to LLP primary legislation.

Corporate transparency and register reform: improving the quality and value of financial information on the UK companies register

This consultation builds on the 2019 consultation and is part of the three papers looking at corporate transparency and register reform. The consultation looks at ways of improving the timeliness of reporting as well as making the process more streamlined as well as assessing the information required to be published.

The consultation sets out proposals under three themes:

Part A: ***How information is submitted to Companies House***

The first part of the consultation focuses on how accounts are delivered to Companies House with the goal of moving towards filing once with government by moving to a fully digital submission of financial statements and extending the digital tagging. It also seeks views on reducing timescales for accounts to be filed.

The BVCA was supportive of the drive towards harmonised reporting portal to reduce the burden on reporting companies but consideration needs to be given to the timing of such reporting (as different authorities have differing timing requirements) and the additional resources and training required to facilitate the digital tagging required as well as the systems to receive the information in a useful way.

Regarding the shortening of timeframes for filing, the BVCA would advise some caution here as reducing the timeframe for reporting would lead to significant burden on UK companies that have large groups (which are common in PE structures) without material benefit.

Part B: ***What information should be filed at Companies House***

The second part of the consultation outlines the information that is currently required by Companies House and asks whether further information might improve the value of the register. Following the last consultation in 2019, there were some concerns that companies were using reduced disclosure exemptions to limit the information provided. The Government is looking to put more onus on the directors to formally confirm the eligibility for these regimes by signing eligibility statements. There is also a desire to make the criteria for small and medium sized companies clearer to allow directors to sign the aforementioned eligibility statements. Further, there were comments raised that financial information was being provided to HMRC and banks for smaller companies and so whether there was merit in including the most detailed set of information as part of the register.

The BVCA was supportive of the measures to introduce eligibility statements, however in order to facilitate this, the rules, thresholds and exemptions that apply to UK companies need to be well understood by UK directors and so could require simplification or further examples to demonstrate the concepts.

Part C: ***What Companies House does with this information***

The final part of the consultation explores what Companies House should do with information it receives in accounts. It sets out proposals to increase the checking of accounts through the better digitisation of accounts and tagged financial information. The consultation asks for what checks would be useful through this tagged data.

The second part of this section asks for views on how financial information could be better displayed on the register through dashboards that demonstrate the key financial information for example. The charities commission is cited as an example of providing a snapshot of key information and potentially a tool that can be replicated.

The BVCA welcomes the provision of additional checks on the assumption that appropriate checks can be made effectively and efficiently, and would cover the requirements of all of the bodies the filing is made to. The BVCA also welcomes a Companies House dashboard that allows users to see key information of a company on an overview page.

11.

Case law update

Tom Alabaster (Ropes & Gray)

11. Case law update

Commercial Court provides a summary judgment in deferred consideration claim despite permission to proceed with a fraudulent breach of warranty counterclaim

Tom Alabaster
Ropes & Gray

Arani v Cordic Group Ltd [2021] EWHC 829 (Comm)

This recent decision serves as a useful reminder of how important it is for a purchaser of a company to remember that its ability to claim for breach of warranty under a share sale agreement is circumscribed by the limitations on liability, and to ensure that any notice of claim that is submitted meets the prescribed contractual standard, is delivered within the requisite timeframe and otherwise complies with these limitations. Equally, the decision underlines the importance of understanding the extent of any broader recourse a purchaser has against the seller under a share purchase agreement beyond a claim for breach of warranty and how any available remedies co-exist and/or may be restricted by the terms of the contract itself or at law.

A sale agreement provided that escrow monies were to be released to a seller at the expiry of the period for notifying claims for breach of warranty, on the proviso that no claim for breach of warranty had been brought by that date. The purchaser failed to release the escrow monies at the release date and subsequently corresponded with the sellers to notify them of certain matters that could constitute a breach of warranty. The sellers brought an application for summary judgment. The purchaser counterclaimed for fraudulent breach of warranties and also for fraudulent misrepresentation. In addition, it sought to set off the amounts it claimed were due to it under these claims against the escrow monies.

The judge gave summary judgment in favour of the sellers for specific performance of the escrow payment obligation under the share purchase agreement. He concluded that the purchaser had no grounds for failing to discharge its obligation to make payment of the escrow monies, on the basis that they had failed to bring their claim within the timeframe stipulated by the contract; and, moreover, that their subsequent correspondence failed to provide the level of detail required by the contract to constitute an adequate notice of claim (full particulars of the grounds of claim, and an estimated claim amount) and could more correctly be categorized as a reservation of rights.

The judge rejected the claim that notification of a claim for fraudulent breach of warranty would entitle the purchaser to withhold the escrow monies. The judge noted in this regard, that the contract drew a clear distinction between standard warranty claims made within a prescribed timeframe, and other claims made outside of this time. The attempted set-off also failed, on the basis that the contract contained a “no set-off” clause which applied to all amounts payable by any party to the agreement (and which on a plain contractual construction applied to claims for fraud under the agreement). The judge did, however, permit the purchaser’s claim for fraudulent breach of warranty to proceed to trial. The judge concluded that the claim for fraudulent misrepresentation should not proceed to trial, on the basis that there was no representation to ground any such claim that was separate to the terms of the warranties themselves. In this connection, he noted in keeping with the recent line of case law, that a warranty cannot amount to an actionable representation in this context.

Supreme Court clarifies issues on parent company liability with respect to its subsidiaries

Okpabi v Royal Dutch Shell plc [2021] UKSC 3

In this recent decision, the Supreme Court has held that a UK incorporated parent company can owe a duty of care in respect of the negligent actions of an overseas subsidiary. This reaffirms the recent decision in *Vedanta Resources plc v Lungowe* [2019] UKSC 20 ("Vendata") as regards tortious liability for the actions of an overseas subsidiary.

The underlying fact pattern related to various oil spills that had allegedly resulted from the business operations of a Nigerian incorporated entity in the Shell Group (Shell Petroleum Development Company of Nigeria Ltd) in the vicinity of the appellants' community. Various individuals alleged that these spills had caused significant environmental damage, including serious water and ground contamination that had not been adequately cleaned up or remediated. The basis of their claim against Royal Dutch Shell plc ("RDS") (the ultimate parent company in the Shell group) was that RDS owed a duty of care to them and was liable for the negligent actions of its subsidiary. Their contention was that this duty of care arose because RDS exercised significant control over materials aspects of the subsidiary's operations and assumed responsibility for the subsidiary by maintaining group-wide policies and guidelines. RDS resisted this assertion and maintained that relevant operational decisions were made at the level of the subsidiary.

The question for the Supreme Court was one of jurisdiction: namely whether the claimants had an arguable case that a UK domiciled parent company owed them a common law duty of care in respect of the actions of its subsidiary, so as properly to found jurisdiction against that company (as distinct from a consideration of the merits of the underlying claim and whether any duty that did arise had been breached).

On the issue of "duty of care", the Supreme Court concluded that the question of whether a parent company is liable for the negligent acts of a subsidiary will be assessed by reference to the normal principles of negligence. To that end, the Supreme Court confirmed that the following non-exhaustive factors would be relevant (reaffirming the approach in Vedanta, but underlining that there is no special test applicable to tortious responsibility of a parent company for the activities of a subsidiary, and that nor is it appropriate to "shoehorn all cases of the parent's liability into specific categories):

- To what extent has the parent company taken over the management or joint management of the relevant activity of the subsidiary?
- Has the parent company provided defective advice and/or promulgated defective group-wide policies which were implemented by the subsidiary?
- Has the parent company adopted group-wide policies and taken active steps to ensure their implementation by the subsidiary?
- Has the parent company held itself out as exercising a particular degree of supervision and control over a subsidiary?

The Supreme Court found that the vertical organisation structure of the RDS group meant that it was seriously arguable that RDS group was organised along business and functional lines, rather than by companies as separate legal entities. As a consequence, it was arguable that the degree of control and de facto management that had been exercised by an English parent company were capable of giving rise to a duty of care.

United States District Court for the Southern District of New York considers an unjust enrichment claim regarding an erroneous payment to lenders

Re Citibank August 11, 2020 Wire Transfers 20-CV-6539 **(JMF)**

Much attention has been given to the widely reported decision earlier this year of the United States District Court for the Southern District of New York in In re Citibank August 11, 2020 Wire Transfers (a.k.a. the "Revlon case"). This decision addressed the situation where an administrative agent made an erroneous payment to lenders and failed in its legal action to recover about $500 million. The Loan Syndications and Trading Association ("LSTA") responded to this decision by releasing a draft "Erroneous Payment Provision" in March 2021, which may eventually be included as standard language in the LSTA forms of credit agreements if generally adopted by the market (although it is yet to be seen how this clause will be adopted). The decision and subsequent release of draft credit agreement language by the LSTA has prompted many in the UK loan market to question how English law deals with mistaken payments and whether the Loan Market Association ("LMA") will address the issues raised in this case.

The case involved a claim of unjust enrichment under New York law by Citibank, N.A. ("Citibank"), which acted as Administrative Agent for a syndicated term loan taken out by Revlon, Inc. ("Revlon") under a New York law governed credit agreement. New York law, which has a common law tradition, generally treats a failure to return money that is wired by mistake as unjust enrichment or conversion unless there is a valid defence. In the case in question, Citibank failed in its claim against the lenders because the court found that the lenders were not unjustly enriched because the "discharge for value" defence applied. In the words of the judge: "the recipient is allowed to keep the funds if they discharge a valid debt, the recipient made no misrepresentation to induce the payment, and the recipient did not have notice of the mistake."

Under English law, there is no equivalent discharge-for-value defence. However, the change of position defence will apply if the defendant can show that its position has changed to such an extent that it would be inequitable in all the circumstances to require it to make the repayment. This defence is more difficult to establish than the discharge for value defence as the defendant will be required to demonstrate that it has suffered a detrimental change in circumstances resulting from the receipt of the enrichment and that it qualifies to rely on the change in position defence. A claim for unjust enrichment could also be defeated by the following general defences: estoppel; bona fide purchase; impossibility of counter-restitution; passing on; illegality and incapacity.

There are also differences in documentary protections for administrative agents in LMA-style facility documentation. These usually state that the administrative agent's duties under the finance documents are solely mechanical and administrative in nature and they therefore include broad protections for the administrative agent, including limitations on facility agent liability to the extent that there is no wilful misconduct or gross negligence. They usually also include indemnities from lenders and borrowers to the facility agent. However, these indemnities also do not apply where any loss arises by virtue of the agent's gross negligence or wilful misconduct. Where an agent is negligent (as opposed to grossly negligent) in making erroneous payments, it might still benefit from the indemnities and exclusion of liability.

LMA-style facility documentation also usually includes clawback provisions, which state that if the facility agent pays lenders without receiving corresponding funds from the borrower, the lenders will repay the funds plus interest. However there are differing views as to the interpretation of the clawback provisions; it is arguable that the provisions do not cover the scenario where the facility agent makes a payment to the lenders even though the borrower has not signalled its intention to make a repayment (as in the Revlon case).

The case will be appealed in the US and it will be interesting to see if the appeal raises further issues of interest to the loan market.

Court of Justice of the EU expands the rebuttable presumption of decisive influence relating to the parental liability doctrine

Goldman Sachs Group v Commission (Power Cables Cartel) Case C-595/18

The Court of Justice of the EU's ("CJEU") decision that Goldman Sachs Group is liable for the infringement of EU competition law by entities in its investment portfolio indicates a heightened risk of financial investors (including private equity investors, hedge funds and investment banks) incurring liability and fines for competition breaches by the companies in which they hold a stake.

In April 2014, the European Commission ("EC") held that 26 entities connected with 11 market participants had infringed Article 101 TFEU by participating in a cartel in which they shared markets and allocated customers within the market for underground and submarine power cables. Among these entities were Prysmian SpA ("Prysmian") and its wholly owned subsidiary Prysmian Cavi e Sistiemi Energia Srl. Goldman Sachs was the indirect parent of these entities for part of the infringement period. The EC presumed that Goldman Sachs had exercised decisive influence over Prysmian and (through Prysmian's decisive influence over its subsidiary) over Prysmian Cavi e Systiemi Energia Srl during the infringement period. It concluded that Goldman Sachs had actually exercised this decisive influence over the Prysmian entities based on the economic, organisational and legal links between the investor and the portfolio companies. In particular, the EC looked at the level of influence conferred by:

- The ability to appoint and remove board members.
- The ability to call shareholders meetings.
- Participation in Prysmian's Strategic Committee.

The EC held Goldman Sachs jointly and severally liable for the part of the fine imposed on Prysmian corresponding to the period in which it exercised decisive influence, totalling EUR 37,303,000.

In June 2014, Goldman Sachs appealed to the General Court. The General Court dismissed the appeal; the EC was entitled to make its presumption of decisive influence as Goldman Sachs held all the voting rights (even where it did not own all of the shares) in Prysmian, which placed it in a situation akin to being a sole owner. Goldman Sachs' ability to control Prysmian's market conduct through board appointments and other measures (including measures put in place to maintain this control following Prysmian's IPO) formed the basis for a finding of decisive influence. The General Court considered that the presumption of decisive influence could be rebutted by Goldman Sachs demonstrating that the investment was purely financial with no involvement in management or control. Goldman Sachs could not demonstrate that this was a purely financial investment.

In September 2018, Goldman Sachs appealed to the CJEU to set aside the decisions of the EC and the General Court or to reduce the fine imposed. The CJEU dismissed the appeal in January 2021, noting in particularly that the finding of decisive influence was justified based on Goldman Sachs controlling all of the voting rights, not due to the level of Goldman Sachs' (indirect) shareholding.

This confirmed a significant expansion of case law in relation to parental liability. The finding of parental liability against an investment company rather than a traditional corporate parent has several key consequences:

- Even where the investor's main objective is not to manage the portfolio company (e.g., to prepare it for an IPO), liability can be presumed where there is strong influence through control of voting rights.
- Where fines are calculated based on turnover, the maximum fine will be considerably higher if the turnover of the parent investor is included.
- The investor may also be jointly and severally liable for claims made by customers harmed by anticompetitive practices (and may be an attractive target with "deep pockets").

Court of Appeal considers lenders' duties in distressed situations

Morley v The Royal Bank of Scotland plc [2021] EWCA Civ 338

The Court of Appeal recently held that that a bank was not under any implied duty to exercise care and skill when undertaking restructuring negotiations with a borrower who had defaulted in its repayments of a loan, and that the bank had not breached its duty of good faith. It also rejected the borrower's claims for intimidation and economic duress.

On the facts of the case, in December 2006, Mr Morley (a commercial property developer) (the "Borrower") charged his property portfolio to Royal Bank of Scotland ("RBS") as security for a £75 million loan provided by RBS. During the financial crisis, the portfolio lost value and the Borrower failed to repay the outstanding debt. RBS and the Borrower entered into negotiations that led to the Borrower entering into an agreement ("the Agreement") with RBS to write off £10 million of the debt and transfer part of the portfolio to a subsidiary of RBS, West Register (Property Investments) Ltd ("West Register") at a price above market value.

The Borrower brought a claim against RBS a few years later. He claimed that, in concluding the Agreement, RBS had breached its duty (implied into the loan agreement under section 13 of the Supply of Goods and Services Act 1982) to provide banking services with reasonable care and skill, and that it had breached its duty to act in good faith. In addition, RBS had threatened to transfer the whole portfolio if an agreement was not reached and to appoint receivers to implement a pre-packaged sale of the portfolio to West Register. On this basis, the Borrower brought a claim of intimidation and economic duress.

The High Court dismissed the claims, finding that RBS was not at fault because it was entitled to pursue its own commercial interests in the restructuring negotiations, which were carried out at arm's length and each side benefitted from legal advice. RBS's threat to appoint receivers was not an unlawful act and it had acted in good faith. Permission to appeal was granted and the Court of Appeal decision established the following three key points:

1. ***Duty to act with reasonable skill and care:*** The court held that RBS did not have an implied duty to exercise skill and care while negotiating with the Borrower: the loan agreement (which had expired) did not include such a contractual term as no such term was implied under the Supply of Goods and Services Act. In any event, the mortgage was not a supply contract. Instead, the relationship between the parties during their negotiations was governed by the express terms of the mortgage and the equitable duties that the bank owed as mortgagee. RBS was entitled to take into account its own commercial interests despite the fact that it stated in its own policy guidance that its objective was to support viable businesses. The language in the policy guidance was, according to the court, purely "aspirational language" and could not be relied upon as a basis for a claim of breach of duty. The court also observed that any receiver

appointed by the bank would have been the agent of the mortgagor and not the bank and would have owed duties to the Borrower to take reasonable care to obtain a proper price. Any decision to transfer the Borrower's portfolio to West Register by means of a pre-packaged sale would have been a decision for the receivers ultimately and not RBS. The court held that, even if the bank had been under such a duty, there had been no breach of duty on the facts.

2. ***Implied duty to act in good faith:*** While the court did not necessarily accept that RBS had an implied duty to act in good faith during the restructuring negotiations, this point did not have to be decided by the court. The court found that RBS had acted in accordance with its commercial interests.
3. ***Intimidation and economic duress:*** The court observed that coercion is an essential element of the tort of intimidation and of economic duress: the threat must be intended to coerce the claimant to take or refrain to take action but if the threat does not in fact coerce the claimant or if no loss or damage is incurred as a result, there can be no claim for intimidation or duress. The question as to whether the tort of intimidation requires a threat to use "unlawful" means or whether it requires a threat to use "illegitimate" means was left open as this was not a factor that needed to be resolved in this case. The Court of Appeal upheld the High Court decision that there was no coercion by the Bank when concluding the Agreement because each party had legal advice and they entered into robust negotiations that led to the conclusion of an agreement that was substantially similar to one proposed by the Borrower himself. The delay of five years in taking steps to set aside the Agreement also worked against the Borrower's claim of coercion.

This decision clarifies the scope of a lender's duty of care to a distressed borrower. A mortgagee is entitled to pursue its own interests in recovering the secured obligations and its duties are not governed by the Supply of Goods and Services Act but rather by equitable principles. The decision also reaffirms the necessary elements for a successful claim of intimidation and economic duress and clarifies the approach that courts will take to the concept of coercion.

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