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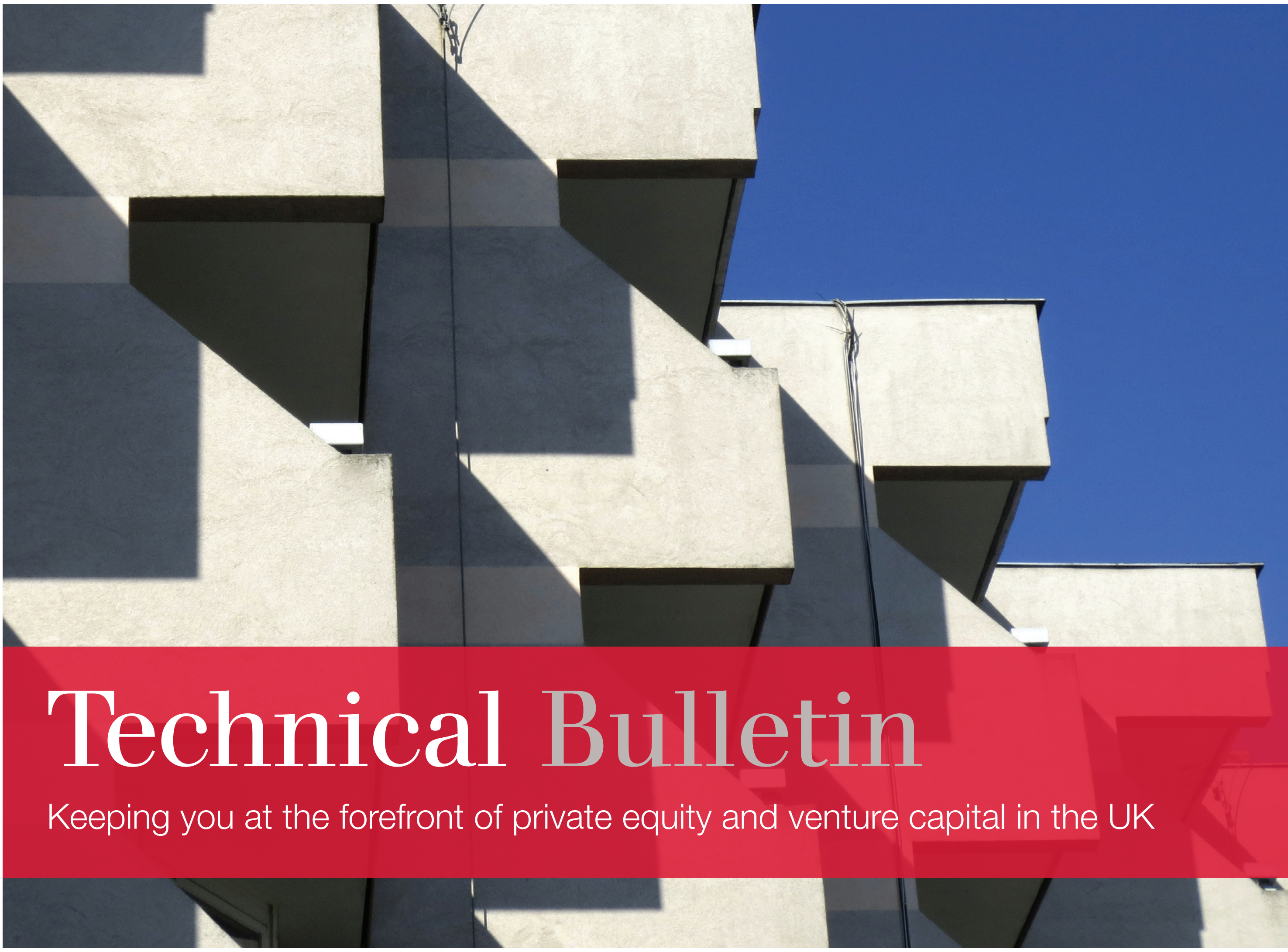
Private Equity &
Venture Capital
Association



Technical Bulletin

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

May 2016

Introduction

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

Over the last six months there have been developments on a number of important topics affecting the tax, legal and regulatory landscape. The three technical committees have continued to monitor these and, when necessary, engage with policymakers in order to shape any emerging regulation. We also strive to keep our members informed of important developments and explain their impact. Key policymakers include:

Our stakeholders		
	BIS	Department of Business, Innovation and Skills
	FCA	Financial Conduct Authority
	FRC	Financial Reporting Council
	HMRC	HM Revenue & Customs
	HMT	HM Treasury
	OECD	Organisation for Economic Co-Operation and Development

What's inside

Simon Witney

Chair
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The changes introduced to the taxation of carried interest by the Chancellor in the Summer Budget 2015 required extensive engagement with HMT and HMRC to ensure the industry was fairly represented and not impacted in ways which were not intended. Members of the Taxation Committee have been, and continue to be, very active in engaging with HMRC and Mark Baldwin has produced a further article on the legislation ahead of the anticipated accompanying guidance, following the Royal Assent of the Finance Bill 2016, as well as a separate piece on incomised carried interest.

The BVCA and the Taxation Committee have sought to ensure the impact on the industry of the OECD's BEPS project is taken into consideration as the OECD implements its proposals, focusing on action points 4 (Interest Deductions) and 6 (Treaty Abuse). As detailed in the last edition of the Bulletin, the OECD published its final reports on Action Points 4 and 6 in October 2015 and since then the UK Government has announced it will introduce a general restriction that limits corporation tax deductions for net interest expense to 30% of a group's UK EBITDA. Our points on a higher de minimis (£2 million), the 30% limit (from a range of 10-30%) and a group ratio rule (which could help groups with high levels of external debt), had been taken on board when implementing the OECD's recommendations. Despite some of the recommendations gaining traction, concerns remain due to the short amount of time before implementation is expected (1 April 2017) and the lack of grandfathering. We will be responding to the recent HMT consultation that examines the finer detail. Regarding action point 6, the OECD had committed to explore solutions for "non-CIV funds" and a consultation on the "Treaty Entitlement of Non-CIV funds" was published at the end of March and our detailed response is available on the BVCA website[1]. Our aim when responding to this action point is to emphasise that structures in the private equity industry are not used for "treaty shopping" and the OECD has now acknowledged it needs to do more to find solutions for alternative funds. Despite a deadline of December 2015, the project is now expected to continue throughout 2016.

The Taxation Committee has also been continuing work on another OECD initiative, the Common Reporting Standard ("CRS"). The BVCA has been in dialogue with HMRC regarding the standard and Jennifer Wheater has written an article to provide an update on the implementation of the regime, what is meant by "controlling persons" and in the interplay with non-participating jurisdictions. In addition, the BVCA expects to launch standard form documents for CRS compliance in the coming weeks which will be available on our website.

On the regulatory front, the updated rules for the new Market Abuse Regulation, which come into force in July 2016, have been set out in an article by James Smethurst & Christopher Crozier. The article details how the new regime's rules differ from current practice and the impact of these changes. An article by Tim Lewis addresses the Securities Financing Transactions Regulation which aims to increase transparency and, consequently, reduce risk in securities financing transactions.

In his note, John Decesare explains the function of the newly established Office of Financial Sanctions Implementation and the difference between the new body and its predecessor. The proposed new financial sanctions enforcement legislation is also explored which, if passed, will include a range of new penalties and an increase in custodial sentencing. Michael Johnson will draw on the most recent announcements regarding the European Commission's Capital Markets Union ("CMU") project, led by President Jean-Claude Juncker and the UK's Commissioner Lord Hill. The article provides an update on how the aims of the CMU are being shaped into actions and what this will mean for the private equity and venture capital industry.

The recent Budget highlighted some positive outcomes for the industry; the Government published its response to the consultation on limited partnership reform and as a result of the considerable efforts of the Legal and Technical Committee and our broader working group's sustained engagement with HMT, we were pleased to see that many of our suggested amendments have been accepted. The finer detail of the amendments will be further explored in the update by Geoff Kittredge and Sally Gibson. Another welcome announcement was the abolition of the Carbon Reduction Commitment Energy Efficiency Scheme, effective from 2019 and a result of a consultation last year on reforming the business energy efficiency tax landscape. There will be a period of transition and Doug Bryden will cover this and the introduction of a single business energy tax in an article on what the future holds for the energy efficiency space.

[1] http://www.bvca.co.uk/Portals/0/library/Files/Government%20Submissions/160422%20BVCA%20response%20to%20AP6%20consultation.pdf

Another longstanding agenda item for the committee is EU audit reform, the requirements and impact of which have been detailed in an article by Iain Bannatyne, Jane Fowler and Sundip Jadeja. This details the actions firms should be taking to comply with the requirements coming into effect for accounting periods commencing on or after 17th June 2016. A summary of case law from the last year has been prepared by Dorothy Murray and Matthew Wild, which covers informative cases relevant to private equity.

Over the past year the BVCA has increased the ways in which it communicates our work to members. One example of this is the webinar on the new UK Modern Slavery Act hosted in conjunction with Environmental Resource Management and representatives from the technical committees, Alison Hampton and Doug Bryden. The webinar[2] outlines the criteria and the timetable (years ending 31st March onwards) for compliance which is applicable to LPs and LLPs, as well as traditional corporates. Those within scope are obliged to publish an annual statement explaining the measures taken to guarantee the absence of two elements; slavery and human trafficking (or the movement of forced labour) in supply chains. Transparency within the supply chain is moving up the agendas of lenders, investors and LPs and therefore compliance will also be important from a public relations perspective.

Additionally, a detailed briefing[3] was recently written by Amy Mahon to communicate the particulars of the persons of significant control ("PSC") register. The implementation of the Small Business, Enterprise and Employment Act, which has been a subject extensively covered in previous Technical Bulletins, was a significant piece of work for the Legal & Technical Committee. The deadline for UK companies and LLPs to establish a PSC register has now passed (6th April 2016) and we would encourage firms to read the briefing to establish steps to take before returns are due at Companies House from 30th June 2016. Details are also provided on the requirements of the EU Fourth Money Laundering Directive which comes into force on 26th June 2017 as the PSC Register requirements overlap with the Directive; however, they do not serve to cover them entirely and therefore the BVCA will remain engaged in this area.

Continuing the theme of transparency and reporting, the Guidelines Monitoring Group was rebranded as the Private Equity Reporting Group[4] in September 2015 and next year marks the 10th anniversary since the original guidelines were published. In light of this, Sundip Jadeja's article sets out the evolving nature and continuing relevance of the Guidelines to the accountability of the industry. The article also ties into the broader theme of transparency which has been prevalent in the political and financial spheres in recent times. Finally, a short note has been prepared to showcase the most recent standard form template published by the BVCA on a request for proposal for the provision of fund administration services[5].

Our committee members

The BVCA is immensely grateful for the time, dedication 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. We would also like to welcome new members to our committees.

2 http://www.bvca.co.uk/ResearchPublications/StandardIndustryDocuments/ModernSlaveryActWebinar.aspx
3 http://www.bvca.co.uk/Portals/0/library/Files/Legal%20&%20Technical2/160330%20BVCA%20Technical%20briefing%20March%202016%20%E2%80%93%20Introduction%20of%20the%20PSC%20Register.pdf
4 http://privateequityreportinggroup.co.uk/
5 http://bvca.co.uk/ResearchPublications/Publications/StandardIndustryDocumentsandGuidance.aspx

	New members on our committees	Members who stepped down
Legal & Technical Committee	Alastair Richardson (3i) Duncan Tennant (Permira) John Atherton (Adveq) Robin Bailey (Pantheon) Sally Roberts (Accel)	
Regulatory Committee	James Smethurst (Freshfields)	Tim Spence (Graphite Capital)
Taxation Committee	Alexandra Hone (ICG) Marius Draghici (Carlyle) Abigayil Chandra (Deloitte) Paul Warn (EY)	Caspar Noble (EY) Paul Megson (Deloitte)

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 or with Gurpreet.

With best wishes,

Simon Witney
Chair, Legal & Technical Committee

David Nicolson
Chair, Taxation Committee

Sheenagh Egan
Chair, Regulatory Committee

Gurpreet Manku
Director, Technical & Regulatory Affairs, BVCA

Legal & Technical Committee	Regulatory Committee	Taxation Committee
Simon Witney (Chair) *King & Wood Mallesons*	Sheenagh Egan (Chair) *Livingbridge*	David Nicolson (Chair) *Bridgepoint*
Alison Hampton (Vice-Chair) *HgCapital*	Alice Nisbet *LDC*	Abigayil Chandra *Deloitte*
Alastair Richardson *3i*	Amandeep Johal *Triton Partners*	Adam Frais *BDO*
Amy Mahon *Clifford Chance*	Christopher Crozier *Permira*	Alexander Cox *Ashurst*
David Higgins *Freshfields Bruckhaus Deringer*	Ed Kingsbury *Dechert*	Alexandra Hone *ICG*
Duncan Tennant *Permira Advisers LLP*	Fidelis Wangata *Pantheon Ventures*	Anthony Stewart *Clifford Chance*
Ed Griffiths *DLA Piper*	Ida Levine *Capital International*	Clare Copeland *European Capital*
Garrath Marshall *Deloitte*	James Read* *Macquarie*	Craig Vickery *Exponent PE*
Geoff Kittredge *Debevoise & Plimpton*	James Smethurst *Freshfields Bruckhaus Deringer*	Dominic Spiri *Terra Firma*
Godfrey Davies	John Decesare *3i*	Fiona Cooper *Starwood*
Graham Hislop *Montagu*	Louise Dumican *Carlyle*	Gareth Miles *Slaughter and May*
Iain Bannatyne *KPMG*	Mark Howard *KKR*	Graham Iversen *Greenberg Traurig Maher*
John Atherton *Adveq*	Oliver Morris *KPMG*	James Markham *Graphite Capital*
John Heard *Abingworth*	Paul Gunner* *Bridgepoint*	Jenny Wheater *Duane Morris*
Jonathan Wood *Weil Gotshal & Manges*	Simon Powell *Advent International*	Jill Palmer *3i*
Julie Bradshaw *Doughty Hanson*	Stephen Robinson *Macfarlanes*	Kathleen Russ *Travers Smith*
Richard McGuire *PwC*	Tim Lewis *Travers Smith*	Maria Carradice *Mayfair Equity Partners*
Robin Bailey *Pantheon*	Secondee: Sam Bishop *Travers Smith*	Marius Draghici *Carlyle*
Sally Roberts *Accel*		Mark Baldwin *Macfarlanes*
Stephanie Biggs *Travers Smith*		Matthew Saronson *Debevoise & Plimpton*
Steve Parkinson *EY*		Michael McCotter *Doughty Hanson*
Thomas Laverty *Macquarie*		Paul Cunningham *Helios Investment Partners*
Trudy Cooke *Terra Firma*		Paul McCartney *KPMG*
Secondee: Guillemette Chamayou *King & Wood Mallesons*		Paul Warn *EY*
		Richard Vitou *Deloitte*
		Sara Clark *PwC*
		Sarah Priestley *Shearman & Sterling*
		Stephen Pevsner *King & Wood Mallesons*
		Tim Hughes *PwC*
	* Maternity cover for committee member	Secondee: Jonathan Hurd *EY*

1. Carried interest: The new CGT regime

Mark Baldwin

Macfarlanes

In his Budget on 8 July last year the Chancellor announced changes to the capital gains tax ("CGT") treatment of carried interest designed to ensure that "individuals will normally be charged to capital gains tax on the full amounts they receive in respect of their carried interest". This legislation is now in force. In fact, it is not simply the case that individuals are liable to CGT on carried interest payments they receive; the new regime is more complex than that. The BVCA was heavily involved in discussions with HMT and HMRC around the legislation introduced to give effect to this policy. Whilst the final form of the legislation was affected by those discussions, there remain a number of areas where the BVCA considers further work is required.

When and how does the new legislation apply?

The new legislation applies where an individual (A) performs investment management services in respect of a collective investment scheme under arrangements which involve at least one partnership (this could be because the fund management vehicle is a LLP or because there is a partnership somewhere in the fund structure) and A receives "carried interest". For these purposes "carried interest" is defined in the same way that it is in the disguised investment management fee ("DIMF") legislation and so if an individual who is within the scope of the legislation receives an amount which does not constitute "carried interest" he may well have a (income) tax charge under the DIMF provisions.

The new regime operates differently depending on whether carried interest arises in connection with the disposal of one or more partnership assets (when a fund partnership sells an asset and a distribution is made to stakeholders including carried interest holders) or in other circumstances (the most usual scenario being where an individual disposes of their carried interest). In the first case, a chargeable gain is treated as accruing to A on the disposal and the amount of the gain is the carried interest distribution he receives less permitted deductions. Where the fund asset being disposed of is on a disposal of which could give rise to a chargeable gain (the sale of shares for example), the effect of this provision is to adjust the CGT result of that disposal so that it gives rise to a chargeable gain computed without any base cost other than amounts paid to acquire the carried interest and certain amounts brought into charge to tax under the employment tax rules in respect of the carried interest. If, therefore, an individual receives a carried interest distribution out of an asset sold at a loss by the fund, he will nevertheless be treated as having realised a gain (and only a gain) on that transaction. If the amount the individual receives could not give rise to a gain (for example, the asset being disposed of is a qualifying corporate bond or the carried interest distribution includes an item of income) the legislation nevertheless treats the individual as making a chargeable gain in respect of that amount as well.

Although an individual will no longer be allocated a capital loss where he receives a carry distribution out of fund assets sold at a loss, he can still use any other capital losses he may have to reduce or eliminate the charge under the new rules. In addition, a late stage change to the legislation allows an individual to elect that his existing capital losses are not absorbed by gains produced by this legislation where they would otherwise be wasted. This is particularly helpful in a case where an individual receives an allocation of income in his carry. An automatic use of carried forward capital losses (which the rules would otherwise require) would not achieve anything by eliminating the gain produced by the new regime because the income will (as is explained later) still be charged to tax as such.

Nothing in the new legislation displaces any income tax charge or any CGT charge arising. As there is the possibility of more than one charge in relation to the same amount, the legislation provides a measure of relief. Where CGT is charged on an individual under these new rules and at any time some other tax is charged on the individual in relation to that carried interest, he may make a claim for a consequential adjustment in respect of the CGT charged under these new rules. So, where an individual receives an amount of income in a carried interest distribution, he will be liable to income tax on that amount, but be able to make a claim for any CGT liability under these provisions to be cancelled. The extension of the legislation to tax a fund manager on amounts received by other people or entities (discussed below) has resulted in this "no double taxation" rule being extended to cover cases where A is taxed on carried interest received by someone else and then another person is taxed on the same amount. What the legislation does not do, however, is give the executive a statutory right of indemnity (e.g. against a trustee) if, as will almost certainly be the case where a trust is involved, he ends up with a tax liability under this legislation but someone else has the money that gave rise to his liability. Because of the complexity of the circumstances where double taxation could arise (e.g. where A is a non-domiciled executive, the carried interest distribution is made to an offshore trust which holds the carried interest and the trust later makes a distribution to A or another beneficiary), the operation of this (beguilingly simple) extension will need to be fleshed out quite significantly in guidance. This is a very detailed area on which the BVCA is continuing to work with the Revenue.

The second circumstance where a charge can arise is where carried interest arises to A in other circumstances. In such a case, the legislation treats him as realising a chargeable gain at that point of an amount equal to the amount of the carried interest less any permitted deductions. The amount on which the individual is charged to tax is the amount of the carried interest he receives, which would most obviously be the amount of any payment he receives on disposing of his carried interest. The original draft of the legislation included some very complicated and draconian provisions which could have treated an individual disposing of his carried interest for no consideration in genuine commercial situations (e.g. if carry was reallocated or forfeited by a leaver) as receiving a highly inflated amount of consideration. These provisions were introduced to discourage individuals from disposing of carried interest entitlements to connected entities with a view to escaping the operation of the new regime. As we will see, this policy objective has now been addressed in a different way and as a result these provisions are no longer in the legislation. An individual is only charged to tax if he actually receives an amount of carried interest, and there are no provisions which adjust the amount he is treated as receiving.

The amount of the gain the individual is treated as realising is the amount of the carried interest he receives less any permitted deductions. “Permitted deductions” are narrowly defined amounts actually paid by the individual to enter into the scheme or acquire his carried interest from someone else or amounts which have been brought into charge to tax as employment income in respect of his participation in carried interest arrangements. Following the 2003 Memorandum of Understanding, carried interest holders who are employees tend to acquire carried interest early in the life of a fund in return for a relatively small payment because the value of the carried interest at the time is low. In the vast majority of cases, therefore, an individual is unlikely to have much in the way of permitted deductions. It may be worth noting here that nothing in the new regime casts doubt on the basic principle that carried interest is not in principle subject to income tax and the 2003 MoU remains fully effective.

Pausing here for a moment, the overall effect of the legislation will be to impose a CGT liability on the individual executive on the entire amounts derived from his carried interest unless the ordinary tax rules would have produced a higher charge (for example if he received a share in dividends or interest in a carry distribution). The legislation does not simply produce a straightforward single CGT charge; it produces a more complex (and potentially higher) tax charge than that and imposes a higher compliance burden. A carried interest holder’s effective tax rate will be hard to predict and is likely to be higher than 28% in many cases.

Internationally mobile executives

Many executives in the private equity industry are internationally mobile and may be living in the UK only for a period whilst they carry out a particular assignment. The new regime presents two particular challenges for such people.

First, a significant number of private equity managers working in the UK are US citizens (or are green card holders) and therefore subject to US tax on their worldwide income. For US tax purposes a US citizen is taxed on his share of partnership gains as they arise. That may not match the typical fund structure used in the UK where tax liabilities tend to be more closely aligned to cash distributions. As a result, the US and UK may tax the carry receipt in different tax years and the net effect of the way the US and UK rules interact (or don’t) could be to subject an individual to tax twice on the same profits. In the past there has always been the potential for such double taxation, but the effect of the remittance basis and the way in which carry has been taxed in the UK have tended to mean that this has been a largely theoretical (and certainly a manageable) issue. Given the very different way the rules now work the risk of a meaningful level of double taxation is greatly increased. This point has been addressed by HMRC acknowledging that the rules designed to prevent double taxation will apply in relation to foreign tax as well as UK tax. So, if an individual suffers US tax in relation to his carried interest, that tax is a permanent tax burden and the individual also suffers a UK tax liability under the new rules, the individual will be able to apply for a reduction in his UK tax liability under these new rules (but not any UK tax he suffers under any other UK tax rules). This relief comes from accepting that the reference to "tax" in the legislation includes foreign tax and not from any specific legislative change. The detail of how this will work in practice will be explained in guidance to be issued in due course.

The second area where the new rules cause difficulty is in relation to individuals who are resident but not domiciled in the UK and who use the remittance basis. The chargeable gain which the new rules produce is treated as a foreign chargeable gain (and therefore a gain which is chargeable to tax on a remittance basis user only to the extent that the amount is remitted to the UK) only to the extent that the individual performs the services relating to the fund in question outside the UK. If this situation arises then two gains accrue, and the Revenue's original draft guidance on the legislation contains some helpful examples of how to make this division. There will, however, inevitably be areas of uncertainty, not least with individuals who have been working on a particular fund for several years long before this legislation was a glimmer in anyone's eye (and therefore who will not have records to demonstrate the extent to which they were working inside or outside the UK at any relevant time).

Although the legislation produces a foreign gain (and by implication a UK gain) and indicates how the amount received is to be apportioned, it does not explain how the ordinary remittance basis rules (in particular the mixed fund rules) interact with the two gains. On the mixed fund point, which has been an area of some uncertainty, HMRC has confirmed that apportioning the carried interest between UK and foreign services will result in separate UK and foreign gains, so there will be no mixed fund in the account of the payer. Where an aggregate amount of carried interest represents both a foreign chargeable gain and a "UK chargeable gain" two separate payments can be made, one in respect of each gain. Provided these amounts are paid separately and never comingled, a mixed fund will not come into existence.

In practical terms, therefore, if 70% of my carried interest relates to UK services and 30% to non-UK services, I receive £1,000 of carried interest, the payer of the carried interest makes two separate payments and a £300 payment (representing the foreign chargeable gain) is paid directly to any non-UK bank account, there will be no remittance of the £300 foreign chargeable gain to the UK. It is possible that, although the parties might at the time of payment consider the UK and non UK elements to be 70/30, later on a different split might be determined (e.g. upon correction of an estimate or mistake). This would not affect the principle of this analysis. If the UK/foreign elements were ultimately determined at 69/31, then the bank account containing the £700 would be a mixed fund consisting of all the £690 UK gain and £10 of the foreign gain. Likewise, if the final answer were 71/29, then the non-UK account would be a mixed fund with a small part of the UK gain (£10) and all the £290 foreign gain. The ordinary mixed fund rules would apply in the normal way to these (slightly) mixed funds.

It is important to remember that this analysis is only relevant to the chargeable gains produced by this legislation. It does not alter the application of the mixed funds rules to the amounts actually received, these actual receipts may represent a mixed fund of different items determined on general principles. It will often be necessary to apply the "ordinary" rules to these "real" receipts as well as applying this interpretation to the "carried interest gains". This is a particularly clear illustration of the way the new regime augments rather than replaces existing rules.

When does carried interest "arise"?

The DIMF rules and the first version of the carried interest rules provided that a tax liability would arise to a fund executive where a sum arose "directly or indirectly" to an executive. In their guidance on the DIMF rules, HMRC stated that a sum arose indirectly to an individual when it arose to an interposed structure (including where the sum is used to fund a co-investment), unless the structure performed a real function that justified it receiving the sum. So, the (properly transfer priced) retention of surplus management fees by a genuine fund management company would not be caught by the DIMF rules, but the rolling up of amounts in a passive interposed vehicle would be. HMRC took the position that this wording was wide enough to catch discretionary trusts of which the individual was a beneficiary or an amount received by a spouse or civil partner.

HMRC's position here had been the subject of sustained criticism and, following changes announced on 21 October 2015, the words "directly or indirectly" arise have been removed and replaced by a comprehensive code which prescribes when a sum which arises to another person will be treated as arising to the executive. The rules are complex (and much less porous), but their aim is clear: to treat a sum as arising to a fund executive in just about any circumstance where the sum arises to someone else but it is reasonable to attribute that sum to the individual's status as an executive.

In summary, a sum will be treated as arising to an individual executive where it arises to:

- a connected person which is not a company, in any circumstances. The definition of connected person is very wide – it includes family members, the trustees of any trust of which the individual (or a family member) is the settlor, corporate entities owned by such trusts etc., or
- any other person (which can include a company), where the individual or any person connected with him has "power to enjoy" the sum. The concept of a power to enjoy is widely drafted and will cover most situations where there is any prospect of an economic benefit to the individual or a connected person.

"Power to enjoy" is limited where the sum arises in a corporate structure. Unless the anti-avoidance override applies, a minority shareholder is unlikely to be treated as having power to enjoy a sum which arises in a corporate. Again unless the anti-avoidance override applies, even a controlling shareholder (or anyone else who is connected with the corporate) is unlikely to be treated as having power to enjoy a sum which arises in a company which is subject to UK corporation tax on its profits, or which pays an amount of foreign tax which is at least 75% of the tax it would have paid if it were UK resident. The stricter rules that apply to connected companies make that definition important. A company is connected if it is controlled by the individual and his or her associates – this is also very widely defined, but the rule that treats partners as associates does not apply here (which will be helpful where the manager is a LLP or the fund uses partnership structures).

On that basis (and put simply), absent the anti-avoidance rules applying, these rules should only apply to sums arising within non-UK corporate structures where a fund executive controls the group and the amounts are subject to less than 15% tax within that structure.

The anti-avoidance condition is met if it would be reasonable to assume that, but for any arrangements, the sum would have arisen to the executive (or a connected person) and it is reasonable to assume that the main purpose (or one of the main purposes) of the arrangements was UK tax avoidance. As a general rule, "avoidance" refers to doing something which "goes against the grain" of the tax legislation and so it would not normally refer to a mainstream choice around how to structure a business (e.g. using a company rather than a LLP). However, the legislation deems the anti-avoidance rule to apply if the sum is used to invest in a collective investment scheme.

Fund managers are required by investors to commit increasing amounts to the funds they manage. Meeting that commitment is a legitimate business purpose and the BVCA raised with HMRC the spectre of working shareholders in entirely UK-based corporate groups which meet co-invest commitment out of taxed UK profits having a personal tax liability under the DIMF or carry rules. HMRC indicated that the legislation should not apply with this effect. The legislation only "bites" where it is reasonable to assume that, but for the arrangements in question, the sum in question would have arisen to the particular individual whom it is sought to tax. It is focused on cases where a corporate structure is used to facilitate individuals applying personal carry (or sums otherwise taxable under the DIMF rules) towards personal co-investment commitments. But, as a general rule, the legislation would not be expected to apply where a corporate business has made a "house" commitment to invest in a fund and kept for itself some of the carried interest in other funds as a way of helping to finance that commitment. We expect that all this will be made clear in forthcoming HMRC guidance.

The future

The story does not stop here. HMRC consulted on the taxation of fund managers' performance rewards more generally and this has resulted in a regime in the current Finance Bill which can "incomise" some or all of an individual's carried interest. This is discussed in the second article on carried interest in this Bulletin. In addition, carried interest within the rules we have just been discussing, will not benefit from the reduction in the ordinary CGT rates; the reduction from (essentially) 28% to 20% does not apply to carried interest gains or residential property gains.

2. Carried interest: Incomised carry

Mark Baldwin

Macfarlanes

In the first article in this Technical Bulletin we considered the changes to the "basic" CGT carried interest regime which took effect last July. In this article we will consider the further changes introduced with effect from 6 April this year which can in certain circumstances treat carried interest (however it is structured) as income.

This regime was introduced because the Government was concerned that the "traditional" carried interest tax regime (as it applied to carried interest paid out of private equity and other long term investment funds) was being accessed by managers of short term (essentially trading) funds. Rather than focus the new regime on carried interest in trading funds (thus preserving the traditional distinction in UK tax law between investment and trading activities), the Government chose to introduce an entirely free standing regime, which does not depend for its operation on existing tax concepts.

As with the first set of changes, the BVCA has been heavily involved in discussions with HM Treasury and HMRC around the draft legislation, which is now significantly different from the first version. Nevertheless, there remain areas of uncertainty and the BVCA is continuing its dialogue with HMRC in the hope of clarifying these areas either in the draft legislation (which is now not expected to receive Royal Assent before the autumn) or in subsequent guidance.

Whom do these rules apply to?

This legislation (unlike the "basic" carried interest regime discussed in the earlier article) applies to an individual who provides investment management services in relation to a collective investment scheme (the FSMA definition) or an investment trust. There is no need for a partnership to be involved in the arrangements.

The legislation does not apply in relation to a carried interest which is an employment related security (broadly, a carried interest acquired by an individual where the opportunity to acquire the interest was made available to him as a result of an employment). HMRC take the view that the employment tax regime provides a complete regime for dealing with such interests.

The new rules apply to carried interest payments arising on or after 6 April this year regardless of when the carried interest arrangements were put in place. This means that the calculations of average holding periods will need to be run by existing funds not just new ones and certain judgment calls (e.g. around what it was "reasonable to suppose" as of the time it started investing a fund would invest in over its life) will need to be made some time after the event.

When and how do the new rules apply?

The new rules seek to identify "income based carried interest". If any part of the carried interest arising to an individual is "income based" then it is taxed under the disguised investment management fee (DIMF) regime. Amounts taxed under the DIMF regime are treated as the profits of a trade carried on in the UK. As well as being subject to income tax and national insurance contributions, the DIMF rules have a very different territorial scope from the ordinary carried interest tax regime.

Where an individual has an interest in a fund he manages, he will normally be subject to capital gains tax or income tax on amounts he receives from the fund if he is resident in this country at the time the amounts arise. In addition, if the individual is a remittance basis user he will be liable to tax only on UK source income and gains from UK situs assets comprised within his carried interest distributions. As we have seen, there is now a modified regime for remittance basis users as far as the "ordinary" carry tax regime is concerned. But the DIMF regime charges to income tax all amounts an individual receives which are caught by those rules (with no reduction in chargeable amounts for remittance basis users) and in certain circumstances individuals who are not UK tax resident but who are involved in providing services in the UK could have a liability under the DIMF regime.

Whether an amount of carried interest is "income based" depends on the average holding period of an investment scheme at the time the carried interest is paid. If the average holding period is 40 months or more, then none of the carried interest in question will be "incomised" under these rules. If the average holding period is less than 36 months, then it all will be and if the average holding period is between 36 and 40 months, then part of it will be.

In order to work out the average holding period of a fund, one needs first to identify the "relevant investments". These are the fund investments by reference to which the carried interest is calculated. The legislation provides that intermediate holding structures are to be disregarded. The purpose of this provision is obvious (to prevent a portfolio which is dealt in regularly being "wrapped" in a vehicle which the manager can say he has held for a much longer period), but it will not always be obvious when a particular vehicle will be an intermediate holding structure.

The average holding period is worked out each time carried interest arises. One looks at each amount invested by the fund and looks to see when that investment was disposed of. It is very important in this context to focus on amounts invested being returned and to ignore income (unless the income payment effectively closes out the investment) and capital profits. So, if I invest £1,000 in 1,000 ordinary shares and after a year I sell 500 of them for £1,000 (so I have doubled my money), I am treated as having invested £500 for a year and the remaining £500 is still invested. The average holding period is weighted, in the sense that one looks at amounts (value) invested, not just the number of situations (portfolio companies, for example) the fund has invested in.

The capital gains legislation is used to work out whether an asset has been disposed of. This can create issues with "loan to own" transactions (discussed below) where the switch from debt to equity will in most cases involve the disposal of one asset and the acquisition of another. There are other examples where this would be the case, such as a reorganisation of an investment which does not fit within the CGT reorganisation rules (which treat the new and old investment as the same).

When running this calculation, we are told to assume that all the investments still held are sold at that time. Clearly, this will produce an artificially low holding period. This is where the concept of "conditional exemption" is very important. The conditional exemption regime is one of the areas which have been significantly improved as the result of representations made by the BVCA. In broad terms, conditional exemption allows an individual to have a "second bite of the cherry" and recalculate the average holding period at a later, more realistic time. To be "conditionally exempt" carried interest must meet a number of conditions the most important of which is that it should arise to the individual within four years of the time when the scheme starts to invest or ten years of that time if the carried interest is calculated on the realisation model (which most private equity carried interest would normally be). If the carried interest would otherwise be income based to any extent and it is reasonable to suppose that, if the carried interest were to arise at the relevant time (which broadly means at the end of ten years from the time when the carried interest actually arises, assuming the fund uses the realisation model), it would not be income based at all, then the individual can make a claim for his carried interest to be treated as conditionally exempt. This means that, at that point he pays tax on his carry assuming it will not be income based at all and subsequently, if it turns out that the carried interest is income based to some extent, he needs to pay the additional tax due as a result together with interest.

Holding periods for particular funds

We noted earlier that the essence of the new regime involves looking at amounts invested and seeing when each amount invested is returned. As well as being a very complicated way of calculating a fund's average investment holding period, this focus on individual cash flows can produce unrealistically short holding periods as compared to the period over which a fund is exposed to a particular situation. In order to address this, there are a number of special rules which are designed to reflect the economic reality of investment holdings. Some of these rules are for particular types of fund and some for particular investment situations.

We will look first at the rules which provide special holding period calculation regimes for particular types of fund. Broadly these rules look to find a date (T1) on which a fund can treat all subsequent investments as having been made and another date (T2) on which a fund can treat all earlier disposals as having been made, i.e. no investment is treated as being made after T1 or realised before T2.

The first regime is for a "venture capital funds" (VC fund). If a VC fund has a "relevant interest" in a trading company or the holding company of a trading group, it can treat T1 for any "venture capital investment" it makes as having been made at the time it acquired its "relevant interest" and T2 as not taking place until either a "relevant disposal" is made or the "scheme director" condition ceases to be met.

The use of quotation marks above shows that there are a number of closely defined terms in this rule. Because the VC fund regime operates in relation to relatively small investments, it has been very carefully hedged about to make sure that it cannot be abused by funds making small investments in the ordinary course.

The first defined term is "venture capital fund" and this refers to a fund which it would be reasonable to suppose (as at the time it starts to invest) would invest at least two-thirds of the amounts it invests in "venture capital investments" and at least two-thirds of the total value invested will be in investments which will be held for 40 months or more (calculated assuming that the fund is a VC fund). A "venture capital investment" is an investment (a) in a trading company or the holding company of a trading group which is unlisted at the time the investment is made and is likely to remain so, (b) where at least 75% of the total amount invested by the fund is invested in newly issued shares or securities convertible into shares and that investment is used in a trade carried on by the trading company or group to support its growth or develop new products/services and not used to acquire shares in the company which are not newly issued, (c) where the first investment made in the company by the fund was made within seven years of the company/group starting to trade and (d) where the "scheme director condition" is met.

The "scheme director condition" crops up later in relation to other funds and this condition requires the scheme (or the scheme and other funds with which it is "acting together") to be entitled to appoint a director of the company or a controlling company and where the scheme director is entitled to exercise typical investor protection rights. One point that has been made to HMRC in relation to this definition is that investors are normally entitled to exercise these protection rights themselves and requiring the scheme director to be able to exercise these rights undermines (potentially fatally) the definitions which use this concept.

A VC fund has a "relevant investment" if, by virtue of a "venture capital investment", the fund has at least a 5% interest in the company or its investments have a value of more than £1m.

From time to time we will encounter references to a fund having a particular percentage interest in a company and these references are to a fund holding a particular percentage of the ordinary share capital of the company where those shares carrying an entitlement to that percentage of voting rights in the company, profits available for distribution to shareholders and assets of the company available for distribution to shareholders in the winding up (but note that the reference is to shareholders and not to "equity holders" more generally).

A VC fund makes a "relevant disposal" if it makes a disposal which has the effect that the VC fund has disposed of more than 80% of the greatest amount invested at any one time in the company.

The next regime is for "significant equity stake funds" (SESFs). A SESF is a fund which is not a VC fund and where it is reasonable to suppose (when the fund starts to invest) that over its life more than 50% of the total value it invests will be in "significant equity stake investments" and more than 50% of that value will be invested in investments which are held for 40 months or more (calculated on the assumption that it is a SESF).

For a SESF T1 is when it acquired a "significant equity stake" and T2 is when a relevant disposal is made or the scheme director condition ceases to be met.

A significant equity stake is an investment in a trading company or the holding company of a trading group where (a) at the time the investment is made the company is unlisted and likely to remain so, (b) by virtue of the investment (on its own or with other investments) the scheme has a 20% interest in the company and (c) the scheme director condition is met.

A "relevant disposal" is one where the fund ceases to have a 15% interest in the company.

A "controlling equity stake fund" (CESF) is one which is not a VC fund or a SESF but where (when the fund starts to invest) it is reasonable to suppose that over its investing life more than half of the total value invested by the fund will be invested in controlling interests in trading companies/groups and more than half of the total value invested will be invested in investments which are held for 40 months or more (assuming the fund is a CESF).

For a CESF T1 is when it acquires a 25% interest in a trading company/group and T2 is when the CESF makes a disposal which results in the CESF ceasing to have a 25% interest in the company.

There are also special timing rules for real estate funds, funds of funds and secondary funds. In all these cases there is a focused definition of the type of investments the fund can make in order to qualify for the particular regime and then a bespoke "T1/T2" calculation rule. The special regime for secondary funds illustrates one important weakness of these regimes. Each of them is a self-contained silo. To qualify as a secondary fund, it must be the case that, looking at the fund at inception, it would be reasonable to suppose that "substantially all" of the total value invested by the scheme will be applied in acquiring investments in unconnected collective investment schemes. Many secondary funds, of course, invest through a mixture of taking stakes in other funds and buying residual portfolios. It is only a fund which invests "substantially all" of its money in buying second hand fund interests which will qualify for this regime. Similarly, a VC fund must invest at least two thirds of its money in qualifying venture capital situations, and one could easily imagine a fund which invests in a mixture of VC situations and other non-controlling stakes such that it fails to qualify either as a VC fund or a SESF.

Special calculation rules for particular assets

As well as there being rules which provide bespoke holding period calculation methods for specific types of fund, there are also rules which seek to provide a particular regime for particular investments.

Many funds find themselves forced to acquire more of an interest in a particular situation than they would ideally like. They would then look to syndicate some of that investment within a relatively short period. A transaction along these lines could artificially pull down a fund's average holding period. Accordingly, the legislation provides for the making and disposal of an excludable "unwanted short term investment" to be disregarded. An "unwanted short term investment" is one (a) which is made as part of a transaction under which the fund acquires one or more other investments, (b) where the value of the "unwanted" investment is not more than half of the total investment value, (c) where it must be reasonable to suppose that the investment had to be made in order for the other investments to be made, (d) where at the time the investment is made the managers of the fund must have "a firm, settled and evidenced" intention to dispose of the unwanted part within the permitted period, (e) where the investment must in fact be disposed of within the permitted period and (f) any profit arising on the disposal must have "no bearing on whether a sum of carried interest arises or on the amount of any sum of carried interest which does arise". Pausing for a moment, that last requirement is quite opaque. It is quite difficult to see how (absent a specific provision to this effect in the fund documentation) a profit arising on the disposal of a syndicated investment would have no bearing at all on whether carried interest is paid and if so how much. Exactly what this means is one of the questions the BVCA continues to explore with HMRC.

As well as being an unwanted short term investment, the investment must be "excludable" which (so far as relevant for these purposes) is a reference to an interest in securities in an unlisted company or a direct loan where the other investments are shares or securities in an unlisted company. Here the permitted period for the disposal is six months, which is quite short.

One important limitation on this rule is that it ceases to apply if at any time it becomes reasonable to suppose that, once the scheme has ceased to invest, more than a quarter of its capital will have been invested in excludable unwanted short term investments. It is easy to envisage circumstances where, long before it has invested a quarter of its money in such investments, it becomes "reasonable to suppose" that at some point over its life the fund will reach that limit. In such a case, the ability to use this regime is turned off at that much earlier point.

The deficiencies of this rule will likely not matter for a CESF or SESF, as their T1/T2 calculation methods are likely to ignore syndications. But they will matter a lot if they shut out other funds and artificially pull down their holding periods.

In a number of cases (so called "loan to own" transactions) a fund may acquire a debt in a distressed company with a view to acquiring equity ownership in due course. When the fund investment "flips" from debt to equity, that would in the ordinary course involve a disposal of one investment and the acquisition of an entirely new one (even though the fund continues to be exposed to the same investment situation). A special rule here provides that where a fund acquires a debt which is uncollectable or otherwise impaired with a view to securing direct or indirect ownership of a company's assets and the fund acquires ownership of the assets within three months of the acquisition of the debt, then the debt and the assets are to be treated as a single investment. Although the sentiment behind this rule is to be applauded, the three-month period is far too short for most funds. The BVCA had previously suggested that in a loan to own transaction, the fund should be permitted to look through to the underlying investments/assets (using the "disregard intermediate structures" rule) and that way one could treat the asset as the same all the way through.

In all cases, where a fund has a controlling interest in a trading company or the holding company of a trading group, it is allowed to treat all of its investments made after the time it acquired its controlling interest as acquired at the time it acquired that interest and disposals made before it ceases to have a 40 per cent interest in the company will not be treated until that time.

Internationally mobile executives

We noted at the beginning of this article that an individual will be caught by these rules if he provides investment management services to a fund whilst resident (or regularly present) in the UK and if he is a remittance basis user he will have no access to that regime.

There is a special regime which provides some help for an executive moving to the UK who has been non-UK resident for at least five consecutive tax years. In the first four tax years immediately after he ceases to be non-resident he can treat income based carried interest relating to pre-arrival services performed outside the UK as arising from a non-UK trade and thus, if he a remittance basis user, can to that extent access the benefits of that regime (subject to avoiding the mixed fund rules).

Conclusion

The current draft legislation is a significant improvement on the original proposals, in particular because:

- the 40 month holding period provides funds with a target they can satisfy with a sufficient margin to avoid investor concerns around perceived conflicts but without damaging HMRC's core objectives;
- the conditionally exempt carry regime now operates to a more realistic timetable;
- the bespoke holding period calculations better reflect funds' real exposure to particular investment situations.

Nevertheless, a number of concerns remain with the proposals. Some of these (e.g. the "loan to own" rules and the narrow definitions of certain types of fund) are points of principle in the legislation. Others are points where clarification will be required in guidance. These do, however, include some quite fundamental concepts, such as how the rule disregarding intermediate structures applies in all cases, as well as how particular rules (such as the requirement that a profit arising on the disposal of a syndicated investment should have no bearing at all on whether carried interest is paid and if so how much if the syndication is to be ignored) operate.

3. Common Reporting Standard update

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The various information exchanging regimes in the form of FATCA, CDOT and CRS are at the point of requiring no introduction or summary of the basic concepts. However, with CRS now in force in some jurisdictions and imminent in others, it is perhaps a good time to consider some of the technical issues still outstanding which relate to investment funds. In this Bulletin we explore three areas which are worth consideration by the funds industry.

Implementation of CRS

The OECD Standard for Automatic Exchange of Financial Information in Tax Matters, the document commonly referred to as the "Standard" or simply "CRS" has no legal force at all. Accordingly, referring to "CRS" is akin to referring to the OECD Model Treaty. It is merely a template and actual arrangements between jurisdictions may vary to a greater or lesser extent. Countries adopting CRS are required, according to paragraph 26 of the Standard to have rules in place "consistent" with the scope of CRS. However, paragraph 19 of the Standard makes it clear that jurisdictions will need to apply the CRS to their own domestic law. This gives considerable scope for variation in interpretation.

For CRS to actually have effect there needs first to be a legal instrument to allow this conceptually. This can include standard double tax agreements, the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (the "Convention") or a typical Tax Information Exchange Agreement ("TIEA"). However, beyond this legal permission there must also be an actual commitment by Competent Authorities to exchange information. Thus, the Standard contains three Competent Authority Agreements (the "Model CAAs") – a reciprocal model, a non-reciprocal model and multilateral model (the "MCAA"). The aim of the MCAA is to streamline the process – signatories to the MCAA need only notify that they wish to exchange information and this can then proceed, potentially with adjustments as the jurisdictions see fit. In relation to the other CAAs, these would be, as with any tax treaty, subject to the terms agreed by the Competent Authorities in question. The MCAA makes it clear that jurisdictions are expected to report information and follow due diligence in a manner "consistent" with the Standard. The other supposedly "model" CAAs state the same thing but these, in a similar manner to the OECD model treaty, can be freely adapted by the countries involved. Thus, countries not participating in the MCAA could, on a bilateral basis, enter into a "CRS-lite" agreement, which may well be less onerous. For the purposes of EU countries, the Directive on Administrative Co-operation or "DAC" now mandates information exchange according to its own standards, which closely mirror the Standard set down by the OECD.

In the context of the above options and their various stages, who is regarded as "participating" in CRS? This is important because the term "Participating Jurisdiction" needs to be established in the context of CRS. The Model CAAs define a "Participating Jurisdiction" as one with which there is an agreement regarding information exchange and which is "identified in a public list". Presumably, the agreement must be with the other country concerned but there is no detail on the type of list in the Standard itself nor in the Model CAAs. The OECD's CRS Implementation Handbook (the "Handbook") indicates at paragraph 97 that each jurisdiction will be obliged to keep a list of those it considers "participating" presumably those with whom it has information exchange agreements. However, given the procedure described above for implementation, this may, obviously, vary. The OECD website contains a list of countries which are "committed jurisdictions". This includes such countries as the Bahamas and Singapore, neither of which has signed the MCAA. In the case of the Bahamas, the government has specifically declined to follow a multilateral route on information exchange. Instead, the Bahamas will adopt information exchange agreements on a bilateral basis. This provides for much more flexibility on the actual terms of the exchange arrangements. If they are consistent with CRS but in an incomplete way or if there are minor inconsistencies would this result in the Bahamas being on or off a country's "list" of participating jurisdictions? Might this result in countries such as the Bahamas (which is mentioned as an example but which is not alone) being regarded as "information exchange havens" through which structures can operate with minimal or no disclosure? This might be especially important in the context of the issue discussed below in which an entity which is otherwise an FI is regarded as an NFE if resident in a non-participating jurisdiction.

Who are the "controlling persons"?

Entities classed as NFEs under CRS must (assuming the Standard is adopted) disclose the identity of their "controlling persons."

The definition of controlling persons is another area of some controversy in the context of CRS. The definition of the term in the Standard is as follows.

"The term "Controlling Persons" means the natural persons who exercise control over an Entity. In the case of a trust, such term means the settlor(s), the trustee(s), the protector(s) (if any), the beneficiary(ies) or class(es) of beneficiaries, and any other natural person(s) exercising ultimate effective control over the trust, and in the case of a legal arrangement other than a trust, such term means persons in equivalent or similar positions. The term "Controlling Persons" must be interpreted in a manner consistent with the Financial Action Task Force Recommendations."

The OECD (in its CRS Implementation Handbook) elaborates slightly by stating:

"The term Controlling Persons corresponds to the term 'beneficial owner' as described in the Financial Action Task Force (FATF) Recommendations. For an Entity that is a legal person, the term Controlling Persons means the natural person(s) who exercises control over the Entity, generally natural person(s) with a controlling ownership interest in the Entity. Determining a controlling ownership interest will depend on the ownership structure of the Entity and control over the Entity may be exercised by direct ownership (or shareholding) or through indirect ownership (or shareholding) of one or more intermediate Entities. For example, Controlling Persons include any natural person that holds directly or indirectly more than 25 percent of the shares or voting rights of an Entity as a beneficial owner. If no such person exists, then any natural person that otherwise exercises control over the management of the Entity (e.g., the senior managing official of the company). For example, an Individual A may own 20 percent interest in Entity B and, although held in the name of Individual C, pursuant to a contractual agreement, Individual A also controls 10 percent of the voting shares in Entity B. In such instance, Individual A should meet the definition of Controlling Person."

The above is not terribly clear and there are several points to consider.

The 25% threshold is about the only meaningful element of the definition which can be derived from the FATF. Nothing else is sufficiently precise to be useful.

It is not really true to say that the term controlling persons corresponds to beneficial owner in the context of the definition set out above. First, the controlling persons are required to be "natural persons" which is not the case with beneficial ownership. Second, the way the definition is phrased could exclude the actual beneficial owners in certain structures. For example, in an entity with multiple shareholders the managing director, who may not be a shareholder, would likely be the controlling person.

In terms of trusts, which can be FIs or NFEs and, if the latter, are mostly but not exclusively passive, the definition seems absurdly broad and would result, in the case of some trusts, persons being reported who have absolutely no control of the trust in the normal sense of the word. In irrevocable trusts, the settlor would still be reported. Beneficiaries could be reported even without being aware they are even a beneficiary of a trust. Some beneficiaries may not be identifiable. Ironically, in the case of trusts which are FIs the reporting requirements are narrower. In such cases, discretionary beneficiaries need only be reported if they receive a distribution during the year in question. The Standard gives the option of applying this requirement to controlling persons for trusts which are passive NFEs and it is to be hoped that a number of jurisdictions will do this. However, in the context of EU countries, which must implement CRS through the DAC, this is not an option since it is not permitted by the DAC.

In terms of the potential ambiguity regarding this definition in other contexts, the concept of controlling persons is generally regarded as one way to potentially address the impact of CRS. Structures can be envisaged in which the individual reported as a controlling person would have no objection to being so, while those who might wish to retain their privacy are able to do so. It is also likely that domestic law interpretation will be important. There is not universal agreement as to how far up the "chain of ownership" an NFE is supposed to enquire to determine controlling persons. The most common view is that once a natural person or persons can be identified enquiries may cease. Under FATCA, enquiries may stop if certain entities are identified before reaching a natural person. For example, if an FI can be ascertained first as controlling a passive NFE, such institution will then, presumably, undertake reporting of information necessary further up the chain of ownership. However, while this is the case under FATCA, it is not within CRS and it remains uncertain how this will be addressed going forward.

A further uncertainty arises in variation in the content of the information exchange report. In some jurisdictions, NFEs are required to disclose the category of "controlling person" a named individual falls into. In others this is not the case.

Certain FIs in non-participating jurisdictions

Fund investors self-certifying their status and entities within fund structures themselves are required to report certain information to requesting FIs. In terms of FIs the process is relatively simple. Since reporting obligations of an FI are a matter for that FI's jurisdiction they need disclose only that they are an FI. In CRS participating jurisdictions, such FI will report information on its own account holders to its own domestic tax authorities. In non-participating jurisdictions, the account holder is simply regarded as the FI, but no further reporting will occur. Accordingly, if an individual owns an entity treated as an FI in a non-participating jurisdiction and that FI itself opens an account in a participating jurisdiction, the individual will not, generally, be reported through CRS.

However, under CRS, an FI which is classed as an "investment entity" by virtue of being "managed by" another FI but which is resident in a non-participating jurisdiction, is treated as a passive NFE and is thus required to name its controlling persons. The idea behind this is simple. As stated above, FIs in non-participating jurisdictions are required to provide very little information – they may simply state they are an FI. Thus, an individual resident in a participating jurisdiction wishing to avoid being reported could easily establish a trust or holding structure in a non-participating jurisdiction which is managed by an FI and thus itself an FI under the "managed by" test. Applying the NFE requirements to such structure renders it much more likely that the person will be reported as a "controlling person".

In the context of investment funds this issue is frequently encountered in the case of non-participating fund of funds, trusts or family offices investing in funds in participating jurisdictions. Commonly, these are US structures since the US is not participating in CRS. In a typical fund of funds situation naming the management team of the general partner as controlling persons appears to be the most common approach. However, there are others. Certain funds and potentially family structures are taking the view that they are not investment entities by virtue of being "managed by" an FI but are investment entities in their own right, with limited partners or family members (in varying capacities) as "customers". This is a very interesting development. It is hard to see how partners in a partnership are "customers" of that partnership or how family members can be "customers" in their own structure. However, it is not beyond the reach of argument in some cases. If this argument can be sustained, then these entities are treated as FIs in non-participating jurisdictions with no further details being reported. In the context of funds receiving a self-certification to this effect, it is important to remember that they are, in the main, able to rely on the same. If they question the classification and receive a reference to technical advice on the point then, even if they may have reservations on this issue, they are perfectly entitled to accept it and, indeed, should do so.

4. The Market Abuse Regulation

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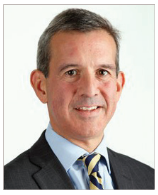

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Summary

The new Market Abuse Regulation ("MAR") comes into force across the EU on 3 July 2016 and will replace the existing civil market abuse regime.

Like the current regime, MAR will prohibit insider dealing, unlawful disclosure of inside information and market manipulation. It will also impose announcement obligations on issuers with shares and other financial instruments traded on EU trading venues, and disclosure requirements on the managers of those issuers.

However, MAR will change the current market abuse rules in a number of important ways: a wider range of financial instruments will be caught by the new regime; a formal regime for market soundings will be introduced; the safe harbour from insider dealing in relation to a takeover offer will be narrowed; the dealing disclosures required from persons discharging managerial responsibilities for an issuer will be widened; and firms will be subject to wider obligations to monitor and report suspicious transactions. This briefing highlights some of the key areas of the new regime that will be relevant to members.

Changes to the FCA rules

In the UK the existing civil market abuse regime in the Financial Services and Markets Act 2000 will be repealed and a significant proportion of the rules and guidance provided by the FCA in its Code of Market Conduct will be removed.

The amended FCA Handbook will not copy out provisions of MAR. Instead, it will contain signposts to the relevant MAR materials and provide some guidance on particular provisions. In the future, firms will have to look at the EU regulation itself and related EU legislation (known as technical standards) to determine whether behaviour is market abuse. The deletion of much of the current FCA guidance may increase uncertainty of interpretation in some areas.

Changes to scope

MAR will widen the number of financial instruments that are covered by the market abuse regime. As a result, MAR will capture behaviour in respect of financial instruments traded on any EU trading venue – being an EU regulated market, multilateral trading facility ("MTF") and, once MiFID 2 comes into force, the new category of trading venue for fixed income and derivative products – the organised trading facility ("OTF"). The current regime only applies to financial instruments admitted to trading on EU regulated markets (although the UK market abuse regime has always been slightly wider, covering trading venues such as AIM). This will bring a larger number of financial instruments and issuers within the scope of the new regime (for example, high yield bonds which are traded only on MTFs).

The regime will also be extended to capture insider dealing and other behaviour in relation to spot commodity contracts where this impacts the price of commodity derivatives traded on an EU trading venue.

Market soundings

Like the current regime, MAR prohibits the unlawful disclosure of inside information (where a person discloses inside information not in the normal course of their employment, profession or duties). However, MAR introduces new formalities that will have to be followed when information is disclosed as part of a market sounding. Failure to follow the requirements could amount to market abuse.

A market sounding happens where an issuer, or adviser acting on its behalf (a 'disclosing market participant' or "DMP"), seeks to gauge the interest of potential investors in a possible capital raising or in the sale of a large block of securities, or where a buyer engages with a target company's shareholders to assess their support for an acquisition. Such soundings will need to comply with detailed procedural and record keeping requirements to fall within the safeharbour from unlawful disclosure.

The new procedures may be relevant to firms that retain a stake in a portfolio company post-IPO which they subsequently want to sell; or to firms contemplating contacting shareholders of a public company to gauge interest in a take private transaction.

In addition, the European Securities and Markets Authority ("ESMA") has published draft guidelines for recipients of market soundings. As proposed, the guidelines will require recipients to implement policies and procedures, including detailed record keeping requirements, to deal with information they receive as part of a marketing sounding. These guidelines will be relevant to firms that acquire or retain stakes in portfolio companies that have shares or bonds traded on an EU trading venue and where shareholders in those portfolio companies may receive market soundings.

Stakebuilding

Under the current regime there is a safeharbour from insider dealing in relation to takeovers and mergers. This safeharbour covers stakebuilding ahead of a public takeover where the buyer has inside information about the target (obtained, for example, from due diligence). MAR removes the safeharbour for stakebuilding where the buyer has inside information about the target. This means that firms contemplating a take private will not be able to stakebuild where they have inside information about the target.

The safeharbour remains available for the launch of the takeover offer. However, at the point of shareholder approval or acceptance of the offer, any inside information that the buyer has about the target must have been made public or otherwise no longer be inside information.

Suspicious transactions

MAR will extend suspicious transaction reporting obligations. Under the existing regime firms must notify their regulator of suspicions of market abuse where they arrange or execute a transaction. MAR requires "any person professionally arranging or executing transactions" to report suspicions relating to "orders" and not only to completed transactions, and to suspicions of attempted insider dealing and market manipulation. Firms that professionally arrange or execute transactions must have systems and procedures to detect and report suspicious orders and transactions. Given the wider scope of financial instruments that will be subject to the new MAR regime, the obligation to report suspicions will also apply more widely. This will be relevant to firms that arrange deals or execute transactions involving shares, bonds and other financial instruments that are traded on an EU trading venue.

Disclosure of inside information

Issuers with shares or bonds traded on an EU trading venue have an obligation to publish that inside information as soon as possible, subject to an ability to delay disclosure where this is in the issuer's legitimate interests and the delay would not mislead the market. If issuers rely on this ability to delay then they must notify the relevant regulator (the FCA in the UK) when they publish the inside information. Issuers will need to keep extensive records of any decision to delay including the reasons for the delay and why they considered the conditions for delay were satisfied.

ESMA has consulted on guidelines on what may be considered 'legitimate interests', and when a delay may mislead the market. These rules and guidelines will be relevant to firms and portfolio companies that have shares or bonds traded on an EU trading venue. At the time of writing the guidelines have not been finalised.

Investment recommendations

MAR requires persons producing or disseminating investment recommendations to ensure information is objectively presented, and to disclose any conflicts of interest. What constitutes an investment recommendation has a broader scope under MAR than under the existing regime. Firms should consider whether they produce and disseminate any information (for example, information provided to investors in their funds) which might be an investment recommendation.

The relevant 'technical standards' under MAR provide further detailed rules on, amongst other things, the identity of producers of recommendations, standards for the objective presentation of recommendations, general standards and additional obligations relating to disclosure of interests or of conflicts of interest and, inevitably, detailed record keeping requirements.

Dealings by PDMRs and closely associated persons

Under the new regime, persons discharging managerial responsibilities ("PDMRs") for an issuer (such as directors) and their closely associated persons (such as certain family members) will have to notify the issuer of transactions in the issuer's shares, debt instruments, derivatives and other financial instruments linked to those shares or debt instruments. The issuer must then make a public disclosure of the PDMR's dealings. MAR introduces an annual threshold of €5,000 or €20,000 (the FCA has indicated the lower threshold will apply in the UK) below which no notifications will be required (although in the UK issuers may choose to continue with the current practice of disclosing all transactions).

The deadlines in MAR for PDMR and closely associated persons to notify an issuer of a dealing and for an issuer to make public disclosure of that dealing are the same, with both required within three business days of the transaction.

In addition, MAR contains new timeframes for "close periods" when dealing by PDMRs is not permitted, and a more restrictive set of exceptions to those restrictions.

The new rules for PDMRs will be relevant to firms that have directors sitting on the boards of portfolio companies that have shares or debt traded on an EU trading venue.

Next steps on MAR

Certain of the detailed rules in MAR's subsidiary legislation and the guidelines referred to above are not finalised. It is expected that the remaining subsidiary legislation will be finalised before 3 July but it is possible that the guidelines will not.

5. The Securities Financing Transactions Regulation

Tim Lewis

Travers Smith

The EU Securities Financing Transactions Regulation (Regulation (EU) 2015/2365) ("SFTR") entered into force on 12 January 2016, although certain obligations will be phased-in over time.

The SFTR is designed to address concerns among EU regulators that there is a lack of transparency about the use of securities financing transactions ("SFTs"), which may contribute to complex chains of risk throughout the financial markets. Many private equity firms may conclude that neither their funds nor their portfolio companies (including the acquisition/holding structure in relation to such companies) use SFTs and that they will not do so in the future. However, these firms will still need to consider whether they need to include SFT and/or total return swap ("TRS") disclosures in fund documents. Firms will also be impacted if they use total return swaps and/or give or receive collateral under title transfer collateral arrangements ("TTCA") or security collateral arrangements ("SCA"), for instance under derivatives agreements. The obligations in SFTR relating to TRS and collateral are not limited to SFTs.

Definition of an SFT

For the purposes of the SFTR, an SFT is any of the following:

- a repo or reverse repo;
- a buy-sell back or sell-buy back transaction;
- a securities or commodities borrowing or lending transaction; or
- a margin lending transaction.

The concept of a "margin lending transaction" is very widely defined under the SFTR as "*a transaction in which a counterparty extends credit in connection with the purchase, sale, carrying or trading of securities, but not including other loans that are secured by collateral in the form of securities*". There have been concerns that, read literally, this definition could catch acquisition finance arrangements, since these frequently involve the use of credit to purchase securities (i.e. the shares of a target company). However, it appears doubtful that the European legislators intended such arrangements to be caught, not least because it may be difficult to apply certain requirements under the SFTR (such as the reporting obligation outlined below) in this context. The European Commission or the European Securities and Markets Authority ("ESMA") may clarify this issue through additional guidance in the future.

The SFTR is partially modelled on the European Market Infrastructure Regulation ("EMIR") and is designed to dovetail with it. A recital to the SFTR confirms that the definition of an SFT does not include derivative contracts as defined in EMIR. However, contracts such as liquidity swaps and collateral swaps, which are not derivative contracts under EMIR, will constitute SFTs.

New requirements under the SFTR

The SFTR introduces a number of different obligations which apply from different dates. These are summarised in the following table and are discussed in further detail below:

Requirement	Arrangements caught	Entities caught	Applies from
Record keeping	SFTs only	Any EU counterparty to an SFT Any non-EU counterparty to an SFT where the SFT is concluded through an EU branch Where an AIF or UCITS is one of the above, obligation likely to be discharged by the fund manager in practice	12 January 2016
Pre-contractual disclosures	SFTs TRS	Above-threshold EU AIFMs UCITS managers	12 January 2016 for AIFs or UCITS funds constituted on or after that date 13 July 2017 for AIFs or UCITS constituted before that date
Collateral reuse requirements (NB reuse has a wide meaning as discussed below)	Any use of MiFID financial instruments received as collateral under a TTCA or SCA (irrespective of whether or not the arrangement arises in connection with an SFT)	Any EU counterparty reusing collateral Any non-EU counterparty reusing collateral in the course of operations of its EU branch Any non-EU counterparty reusing collateral constituting financial instruments provided by an EU counterparty or the EU branch of a non-EU counterparty	13 July 2016, including in relation to collateral arrangements that remain outstanding on that date
Periodic disclosure requirements	SFTs TRS	Above-threshold EU AIFMs UCITS managers	13 January 2017
Reporting to trade repositories	SFTs only	Any EU counterparty to an SFT Any non-EU counterparty to an SFT where the SFT is concluded through an EU branch Where an AIF or UCITS is one of the above, the obligation must be discharged by the fund manager	Phased implementation depending upon the regulatory status of the relevant entity The first possible date will be determined by the date that the delegated regulation on SFTR reporting is adopted, but is unlikely to be before Q1 - Q2 2018 at the earliest

Record-keeping obligation

Since 12 January 2016, EU counterparties to SFTs and non-EU counterparties who enter into SFTs through one of their EU branches have been required to maintain a record of the conclusion of the relevant SFT and any subsequent modification or termination of the transaction. In practice, this would appear to mean that non-EU AIFs (whether managed by an EU or non-EU AIFM) are not normally subject to the record keeping requirement. This is because although the AIFM will enter into the SFT on the AIF's behalf, it is normally the AIF itself that is the principal counterparty to the SFT and a non-EU AIF will not be acting through its own EU branch.

The SFTR does not prescribe any particular form for the relevant records, so the original transaction documentation would appear to be sufficient, provided that it can be located and reproduced within a reasonable timeframe in response to a regulatory request.

It is likely that where a fund is the principal counterparty to an SFT, in practice the fund manager will need to discharge the record-keeping obligation on the fund's behalf.

Investor pre-contractual disclosure requirements regarding SFT and TRS

Since 12 January 2016, above-threshold EU AIFMs (i.e. including full-scope UK AIFMs) have been required to include certain information in their pre-contractual Article 23 AIFMD disclosures relating to the SFTs and total return swaps that they are authorised to use in connection with the relevant fund.

The information that must be disclosed is set out in the SFTR, but may be further supplemented by additional technical standards that ESMA may draft in response to evolving market practices.

This requirement currently only applies if the AIF was constituted on or after 12 January 2016; if the fund was constituted prior to that date, this obligation will apply from 13 July 2017 instead (although for a closed-ended fund, marketing is likely to have ceased by then anyway). The SFTR does not specify when a fund is deemed to have been "constituted", but in practice the industry appears to be taking the view that this refers to the date on which the legal vehicle constituting the fund is established.

In Consultation Paper 16/14 (May 2016), the FCA has proposed making changes to its FUND handbook to cross refer to these requirements. The FCA proposes to include guidance in FUND 3.2.4AG that a full-scope UK AIFM of an AIF that does not engage in SFTs or TRS is not required to include any additional information in pre-contractual documents.

Collateral reuse requirements

From 13 July 2016, new requirements will apply to the right to reuse collateral and the exercise of the right to reuse collateral in the form of MiFID financial instruments (but importantly, not cash collateral). The requirements apply to:

- any EU counterparty to a collateral arrangement; and
- any non-EU counterparty to a collateral arrangement where either:
  - the reuse is effected in the course of operations of an EU branch of that counterparty; or
  - the reuse concerns financial instruments that were provided by an EU counterparty or the EU branch of a non-EU counterparty.

The collateral arrangement does not need to be connected to an SFT to fall within scope.

The concept of "reuse" has a wide meaning under the SFTR, being the use of collateral by a receiving counterparty that comprises:

- the exercise of a right of reuse under an SCA; or
- the transfer of title to the collateral to the receiving counterparty under a TTCA.

However, the concept of reuse does not include the liquidation of a financial instrument in the event that the counterparty that provided the collateral defaults on its obligations under the relevant agreement.

For example, an AIF may be the principal counterparty to OTC interest rate derivatives which provide for two-way movement of collateral. Depending on the documentation governing the arrangements, collateral may be (and under English law-governed agreements, often is) provided by way of a TTCA. The receipt of collateral in the form of financial instruments by the AIF under a TTCA or appropriation of securities under an SCA would constitute "reuse" under the SFTR. As a result, an AIF that could receive such collateral would need to ensure that it complies with the SFTR collateral reuse requirements below.

The precise obligations that apply depend upon whether the relevant arrangement is an SCA or a TTCA. However, in both cases, a counterparty that has the right to receive collateral must disclose the risks to the counterparty that provides collateral that would result from granting a right of reuse under an SCA or from concluding a TTCA. In April 2016, five industry associations (AFME, FIA, ICMA, ISDA and ISLA) published a standard form information statement designed to satisfy these risk disclosure requirements in the context of industry standard agreements such as the Credit Support Annexes to the ISDA Master Agreement or the Global Master Repurchase Agreement. This may set a benchmark for SFTR risk disclosures by the broader financial services industry in due course.

In addition, the SFTR requires the receiving counterparty to obtain the prior express written (or equivalent) consent of the providing counterparty to the conclusion of an SCA containing a right of reuse or to the conclusion of a TTCA. It is unclear whether the existing wording in industry standard agreements (such as the English law-governed Credit Support Annex to the ISDA Master Agreement) is sufficiently clear to satisfy this requirement for express consent, although it is possible that the industry may adopt a pragmatic approach and assume that it is until a regulatory authority gives a contrary indication.

The SFTR also requires that the financial instruments received under a collateral arrangement must be transferred from the account of the providing counterparty (although there are certain derogations for securities accounts maintained in, and subject to the law of, a non-EU country). This has led to some uncertainty about how this requirement can be satisfied where the counterparty providing the collateral holds it securities in an omnibus account with other entities. There is as yet no clear guidance on this issue, although it is possible that ESMA and/or the European Commission could provide clarification in the future.

The collateral reuse requirements apply to all collateral arrangements that exist on 13 July 2016, with no apparent "grandfathering" treatment for pre-existing transactions. As a result, if existing arrangements do not comply with the above requirements and will remain outstanding on 13 July 2016, it will be necessary to take steps to ensure compliance by that date.

Investor periodic disclosure requirements

From 13 January 2017, above-threshold EU AIFMs will need to include additional disclosures in the Article 22 AIFMD AIF annual reports relating to the AIF's use of SFTs and TRS. The precise information to be included is set out in the SFTR and is fairly granular in nature.

As with the pre-contractual disclosure requirements discussed above, ESMA may supplement the periodic disclosure requirements with additional technical standards in the future to reflect evolving market practices.

The FCA's CP 16/14 proposes including guidance in FUND 3.3.7B G that a full-scope UK AIFM of an AIF that does not engage in securities financing transactions or total return swaps is not required to include any additional information in the AIF's annual report.

Reporting SFTs to trade repositories

The SFTR introduces a reporting obligation for SFTs which is similar to the derivatives reporting obligation under EMIR. The SFT reporting obligation will apply to any EU counterparty to an SFT and any non-EU counterparty to an SFT where the SFT was concluded in the course of operations of the EU branch of that counterparty. As with the record-keeping obligation above, in practice this appears to mean that non-EU AIFs (whether managed by an EU or non-EU AIFM) are not within scope of the reporting obligation. There are certain limited exemptions from the reporting requirement – for example, in relation to SFTs entered into with a central bank of an EU Member State. Reporting may be delegated to a third party (including, it would appear, the other counterparty to the transaction), but any entity that delegates reporting would remain responsible for compliance with the SFTR.

Details of the entry into, modification or termination of an SFT must be reported on a T+1 basis to a trade repository which has been registered or recognised in accordance with the SFTR. It is currently expected that a number of trade repositories that are registered under EMIR will expand their services to include SFT reporting and the SFTR provides a "fast-track" registration mechanism for such repositories. The SFTR expressly provides that where an AIF is the principal counterparty to an SFT, the relevant AIFM is responsible for submitting the report on the AIF's behalf.

Although the SFTR provides a broad outline of the minimum content of reporting, ESMA is currently consulting on the specific granular reporting obligations that will be included in the delegated regulation on SFT reporting. Its first discussion paper on this issue (ESMA/2016/356) was published in March 2016 and the consultation period ended on 22 April 2016. A consultation paper containing the draft legislative text will follow in due course.

The date from which the reporting obligation will apply depends upon two key factors: first, the date on which the delegated regulation on SFTR reporting takes effect and secondly, the precise regulatory status of the relevant counterparty. The earliest realistic date for SFT reporting to begin is expected to be around Q1 - Q2 2018, with MiFID investment firms and CRD IV credit institutions (and their third country equivalents) becoming subject to the obligation at that time. SFT reporting in relation to AIFs will begin 6 months after that date – i.e. this is currently expected to start in Q3 - Q4 2018.

There will be a limited "back-filling" obligation where an SFT that was entered into prior to the first reporting date will need to be reported if:

- the SFT remains outstanding on the date that the counterparty becomes subject to the reporting obligation; and
- the remaining maturity on the SFT on that date exceeds 180 days (or, if the SFT has an open maturity, it remains outstanding 180 days after the first reporting date).

Where the back-filling obligation applies, the SFT must be reported within 190 days of the date on which the counterparty first became subject to the reporting obligation.

6. The Office of Financial Sanctions Implementation

John Decesare

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On 31 March 2016, the UK Government established the Office of Financial Sanctions Implementation ("OFSI"). This new body, which sits within HMT, is responsible for ensuring that financial sanctions are "properly understood, implemented and enforced". There is an expectation that the OFSI will be more effective than the previous HMT financial sanctions department, both in terms of giving guidance on the application and interpretation of sanctions (which are not always clearly and precisely drafted) and in respect of their enforcement. There is much commentary about OFSI being introduced to address the perceived differences in approach to the enforcement of financial sanctions by the UK and US Governments, suggesting that the UK may seek to follow the lead of the US Treasury Office of Foreign Assets Control in an attempt to enhance the UK's reputations for financial sanctions enforcement. All this comes at a time when the UK Government wishes to update the UK sanctions regime prior to the FATF review of the UK in 2018.

The launch of OFSI coincides with proposed new financial sanctions enforcement legislation in the form of the Policing and Crime Bill. If passed, this will bring the UK enforcement regime much closer to the US model. Currently, it is only possible to pursue criminal proceedings for breaches of sanctions. However, the new legislation would, whilst preserving and enhancing the criminal remedies, also provide for a range of new administrative penalties, including monetary penalties on individuals and organisations. This would be a significant development, allowing OFSI to impose significant penalties on a lesser "balance of probabilities" test. Coupled with other new enforcement measures, such as Deferred Prosecution Agreements and Serious Crime Prevention Orders, OFSI will have more enforcement options available to it than its predecessor.

The establishment of OFSI and the proposals for tougher enforcement suggests that the UK Government wants to ensure that sanctions are, and are seen to be, more effectively enforced. Firms should take note of this and should take the opportunity of reviewing current HMT and FCA guidance on financial sanctions and their own sanctions compliance policies and procedures to ensure they are appropriate. This should include having a suitable sanctions policy, ensuring that due diligence and sanctions screening procedures are adequate and providing refresher training to staff on sanctions and their role in ensuring compliance.

7. Capital Markets Union – an update

Michael Johnson

BVCA

Introduction

Although the free movement of capital is enshrined in the Treaty of Rome as one of the European Union's four fundamental freedoms (along with the free movement of goods, services and labour), Europe's capital markets could be better integrated. Despite the European economy being roughly the same size as the US economy, US SMEs raise five times more funding from capital markets than European businesses. Similarly, Europe's equity markets are half the size of those in the US, while its debt markets are less than a third of the size.

The Capital Markets Union ("CMU") initiative—led by UK Commissioner Jonathan Hill—sets out to address this by taking a wide range of measures to identify and remove barriers to the free flow of capital across Europe. In short, CMU is about making Europe's capital markets as deep and accessible for small and medium sized businesses as the US's. Ultimately, it is hoped, this will produce more jobs and growth, and by making European businesses less dependent on bank finance, a more resilient financial system.

The first steps towards CMU were taken with the publication of a Green Paper in February 2015. Supporting and growing the venture capital industry featured heavily, with the Green Paper noting that if Europe's venture capital markets were as deep as those in the U S, an additional €90 billion of financing would have been available to European companies between 2008 and 2013.

After taking evidence on the Green Paper, the Commission published an Action Plan at the end of September 2015. It includes 33 measures to be implemented before 2019 as part of the initiative. The Commission's 'first status report' on CMU, published in April 2016, outlines the progress on the actions to date, and looks ahead to further actions due by 2019.

Steps taken thus far

Several of the measures contained in the Action Plan have already been set in train, with the Commission publishing a number of consultations alongside the CMU Green Paper and Action Plan.

Prospectus Directive

At the same time as the Green Paper was published, the Commission launched a review of the Prospectus Directive, which sets pan-European rules on when a prospectus document must be published in advance of a public offering and the form the prospectus must take. The aim of the review is to create a simpler, faster and cheaper regime, and to streamline the process for companies that are doing second rounds of fundraising.

Although only a small proportion of private equity exits take the IPO route, a less burdensome prospectus regime could enhance exit opportunities. We contributed to Invest Europe's February 2016 position paper on the Prospectus review which calls for a number of measures to be adopted that would benefit the private equity and venture capital industry:

- Raising the *de minimis* threshold below which no prospectus is required from offers of €2 million over 12 months to offers of €50 million over 12 months (the latest draft text has the threshold at €10 million);
- Waiving the requirement to produce a prospectus for offerings to sophisticated investors such as high-net-worth individuals and experienced investment professionals;
- More flexibility on the length of the prospectus document, and;
- A wider application of the less onerous minimum disclosure regime that will apply to SMEs and second offers.

As things currently stand MEPs are considering amendments to the Commission's proposal, with a vote on a final report by the Parliament likely to take place in mid-June, although this could be postponed. Regular meetings are taking place in the Council, with the Council Presidency aiming for a political agreement among Member States by the summer.

Cumulative impact assessment of financial regulation

A cumulative impact assessment of existing financial regulation is currently underway as part of CMU. The Commission will not be making any fundamental changes, rather it is aiming to identify any gaps, inconsistencies and unintended consequences within the regulatory framework that was devised in the heat of the financial crisis. The Commission has noted that respondents to a consultation that closed in January coalesced around three broad themes:

- Insufficient proportionality in legislation;
- The negative impact on the amount of financing available to the wider economy; and
- Excessive regulatory burden due to unexpected interactions, duplications and inconsistencies.

Invest Europe's comprehensive response to the review, which the BVCA fed into, highlighted almost twenty examples of the existing regulatory framework for the private equity and venture capital industry not working as it should. These spanned a number of areas including, but not limited to, unnecessary regulatory constraints on financing, such as overly restrictive state aid rules for venture capital; reporting and disclosure obligations under the AIFMD; the application of the proportionality principle to remuneration and passporting rules; and the imposition of fees by some host Member States before allowing GPs to use the AIFMD and EuVECA marketing passports.

The Commission is analysing the feedback received and a further report will follow later this year, with comments feeding into scheduled reviews of individual pieces of legislation.

Debt-Equity Bias and the Common Consolidated Corporation Tax Base

As part of CMU, the Commission has re-launched the drive for a Common Consolidated Corporate Tax Base (CCCTB). The initiative proposes a single set of rules that cross-border companies can use to calculate their taxable profits in the EU. Originating in 2011, CCCTB has been the subject of technical discussions in the Council for the last five years. In order to progress the areas where agreement between Member States has already been reached, the CCCTB has been broken down into stages, with the more ambitious features of the proposal postponed in order.

A consultation that concluded in January focused on addressing a perceived corporate debt-to-equity bias. Three options to change the tax treatment of debt and equity costs were proposed: disallowing any financing costs being treated as deductible expenses; allowing a notional deduction for the cost of equity; or a 'capital allowance' that would not discriminate between equity and debt finance.

The Invest Europe response disputed the notion that there was a debt to equity bias in Europe, and argued that debt and equity financing are complementary rather than mutually exclusive. Further, it suggested that all of the three options proposed were likely to directly or indirectly increase the tax burden on business.

A legislative proposal is expected from the Commission in the fourth quarter of 2016.

Insolvency

Another area where work has commenced is an attempt to harmonise national insolvency rules. The Commission launched a consultation on the proposals in March, which focuses on debt restructuring and debt discharge for entrepreneurs. The BVCA is working with Invest Europe to draft a response and legislative proposal is expected by the end of the year.

STS Securitisation

Also published alongside the Green Paper was a proposal intended to revive Europe's securitisation markets. In 2014, the European securitisation market was worth €214 billion—a third of its value in 2007. By restoring the market to its pre-crisis average, it is hoped that an extra €100 billion of credit can be generated for the European economy.

The Commission's proposal sets out criteria for "simple, transparent and standardised" (STS) securitisation, with reduced bank capital requirements for securitisations that meet the requirements and lower capital requirements for insurers to follow in due course. Although the proposal was agreed by the European Council swiftly, it is still being debated in the European Parliament.

Actions yet to come

The momentum behind the CMU initiative is likely to build in the final two quarters of 2016 with many of the plans that will be of most interest to the private equity and venture capital industry due to be commenced by the end of the year.

Venture Capital

The CMU Action Plan also proposes to review the EuVECA regulation—the voluntary regime for venture capital funds, with access to a marketing passport and a less onerous compliance burden than the AIFMD. Take up of the EuVECA passport has, however, been poor, and a Commission consultation that concluded in January sought evidence on how to increase its attractiveness.

The industry response highlighted that because many national private placement regimes are not open to smaller fund managers, and the eligibility criteria for the EuVECA passport are too restrictive, particularly in respect of qualifying investments, many smaller fund managers are having difficulty marketing outside their home jurisdiction. It recommended that EuVECA be made more flexible, and that it should be complemented with a similar scheme targeted at fund managers that fall below the €500 million AIFMD threshold. The submission also argued that larger fund managers who would normally be subject to the more burdensome requirements of the AIFMD should be able to offer a EuVECA fund as long as the fund's investment strategy met the regulations requirements.

By the summer, the Commission is expected to issue a proposal to amend the EuVECA legislation to "open up the market to a wider set of investors and increase the range of companies that can be invested in".

A public-private pan-European venture capital fund of funds of at least €500 million has also been proposed as part of CMU. The Commission plans to use its own cash to leverage in funds from major institutional investors. With the average size of European venture capital funds at €60 million—just half the average size of the US's—the Commission hopes that attracting more investment into venture capital will enable funds to make larger investments that could begin to bridge the 'equity gap' that many scale-up companies face.

A call for expressions of interest to manage the new fund-of-funds will be issued to fund managers before the summer.

There will also be a study on tax incentives for venture capital and business angels next year, an area that will be of considerable interest to those managing venture capital trusts and enterprise investment schemes, as their activities can be restricted by EU State Aid rules. This has caused challenges in the UK over the past year where venture capital trusts have been prevented from funding buyouts and acquisitions. We therefore welcome and will participate in the study which will look at how tax incentives support start-ups and SMEs and promote best practice among Member States.

Marketing funds across borders

The Commission has launched a consultation on the main barriers to the cross-border distribution of investment funds, covering the functioning of the AIFMD and EuVECA marketing passports, the imposition of fees by some Member States' regulators and taxation—points raised by the industry response to the initial CMU Green Paper, as well as in other submissions.

This is another opportunity for the BVCA, and our European counterparts, to underline concerns about the challenges with respect to marketing following the implementation of the AIFMD across Member States and the need for the Commission to enforce the Single Market.

Regulation of insurers

The Commission has already reduced the capital charges on investments in infrastructure and European Long Term Investment Funds for insurers under the Solvency II framework—something that the industry called for in its response to the Commission's initial CMU Green Paper. EIOPA, the supervisory authority for insurers, is also consulting on whether insurers' investments in infrastructure corporates should be subject to a similarly reduced capital charge.

More importantly, however, preparatory work has begun on whether to change the prudential treatment of private equity and privately placed debt in the Solvency II regulation with a full assessment planned in 2018. The capital charge for private equity investments in closed-ended and unleveraged alternative investment funds (EuVECAs are subject to the same treatment) is currently 39% under the Solvency II standard formula—down from an initial proposal of 49% following a successful lobbying effort by the BVCA and Invest Europe.

However, we believe the risk associated with private equity investments is lower. When the Solvency II review begins in 2018, we will make this point to the Commission, and reiterate concerns about the suitability of the market-consistent valuations insurers are required to use for illiquid assets for which daily prices are not readily available, such as private equity and venture capital.

Direct Lending Funds

The BVCA will also be monitoring the developments surrounding a potential European framework for loan origination by investments funds, given the growth in fund managers with a direct lending strategy. ESMA has already produced an opinion that outlines the key considerations for an EU framework for direct lending funds, including:

- Whether direct lending fund managers should be required to be authorised under AIFMD, and whether there should be further requirements in addition to those contained in AIFMD;
- Whether the funds themselves (as opposed to the fund manager) should be authorised;
- Whether and to what degree funds that originate loans should be limited to loan origination;
- Whether retail investors should be allowed to invest in direct lending funds; and
- Whether and to what degree redemptions should be allowed from direct lending funds, and what liquidity and leverage requirements would be required.

The Commission is set to begin work on assessing the case for an EU-wide framework for direct lending funds in the fourth quarter of this year.

Conclusion

Although DG FISMA recognises that no single measure in the Action Plan is sufficiently radical to break down the barriers to the cross-border flow of capital, it expects all of the actions taken together to have a big impact on European capital markets. As Jonathan Hill put it in a recent speech, “My approach is to go step by step, not trying to go for some top down grand vision, but to build confidence and momentum from the bottom up… There is no silver bullet, no single lever I can pull, but rather a mix of inter-connecting measures that will together help create a stronger and deeper single market.”

The potential benefits for the industry will naturally depend on the detailed implementation, and the BVCA will remain engaged as the policy work evolves.

8. Limited partnership reform in the UK: Latest update

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Introduction

In the Technical Bulletins of April 2014 and November 2015[6], we wrote about the BVCA's work with HMT on the possible reform of UK limited partnership law. The BVCA made a number of recommendations to HMT on how UK limited partnership law could be improved from the point of view of the private funds industry.

Since those articles have been written, HMT has published a summary of the responses to its consultation paper, 'Proposal on using legislative reform order to change partnership legislation for private equity investments'[7]. The responses broadly were very positive and the Government seems on track to implement, in one form or another, its limited partnership law reform agenda.

This article summarises the proposed reforms set out in the consultation, taking account of the responses to the consultation in respect of such reforms[8].

Background

The principal legislation applicable to UK limited partnerships is the Partnership Act 1890 (the "1890 Act") and the Limited Partnerships Act 1907 (the "1907 Act").

The 1907 Act has remained in force with only minor amendments since its enactment at the turn of the 20th century. There have been attempts in the past to reform UK limited partnership law, but with limited success.

The aim of the proposed reforms set out in the consultation is to ensure the continuing competitiveness of English and Scottish limited partnerships as private fund vehicles – with a focus on reducing administrative burdens and increasing flexibility to accommodate the ever evolving needs of fund sponsors and investors.

The proposed reforms are technical in nature. If enacted, they would bring UK limited partnership law into line with limited partnership law in other jurisdictions in which private funds typically are established (such as the Cayman Islands, the Channel Islands, Delaware and Luxembourg) in certain key respects.

Current status

HMT is able to reform UK limited partnership law insofar as that reform would benefit the UK asset management industry[9]. Accordingly, the proposed reforms set out in the consultation are intended to impact a sub-set of limited partnerships only, i.e, those that are used for private funds[10].

The proposed reforms (as modified to take account of responses to the consultation) are based on the reforms recommended by the BVCA.

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6 This article consolidates the information previously provided on this topic in the 2014 and 2015 Technical Bulletins and sets out the current position in respect of the various matters on the subject of potential reform.
7 The consultation paper was published on 23 July 2015 and the consultation period ended on 5 October 2015. For the consultation paper and draft legislative reform order, see: www.gov.uk/government/consultations/consultation-proposal-to-use-a-legislative-reform-order-to-change-partnership-legislation-on-collective-investment-schemes.
8 The government received 22 responses to the consultation.
9 In general, UK limited partnership reform falls within the remit of the Department of Business, Innovation and Skills (BIS) and BIS currently is not pursuing reform to UK limited partnership law.
10 For the purposes of this article, English and Scottish limited partnerships fall within the category of 'UK limited partnership'. A number of respondents to the consultation focused on the fact that some of the proposed reforms would be beneficial to limited partnerships generally, as opposed to applying those reforms only to private funds.

(A) Application of proposed reforms

As stated above, the proposed reforms are intended to impact a sub-set of limited partnerships only, those that are 'private fund limited partnerships'.

A limited partnership will be capable of qualifying as a 'private fund limited partnership' if the following conditions (known as the 'private fund conditions') are satisfied:

- the limited partnership is constituted by a written agreement, and
- the limited partnership is a 'collective investment scheme'[11] (or would be but for any of the exemptions set out in the Financial Services and Markets Act (Collective Investment Schemes) Order 2001).

A UK limited partnership, whether established before or after the implementation of the proposed reforms, that satisfies the 'private fund conditions' may be designated as a 'private fund limited partnership' at any time (i.e., as long as the UK limited partnership is capable of satisfying the private fund conditions at the time designation as a 'private fund limited partnership' is sought, such UK limited partnership will be so designated).

A limited partnership that satisfies the 'private fund conditions' but is not designated as a 'private fund limited partnership' will not be a 'private fund limited partnership'.

It is not possible for a 'private fund limited partnership' to be re-designated as a (non-private fund) limited partnership. Once designated as a 'private fund limited partnership', the 'private fund conditions' have no continuing relevance.

(B) Rights of limited partners

Currently, if a limited partner of a UK limited partnership takes part in the management of the partnership business, it will have unlimited liability for the debts of that limited partnership incurred while it takes part in the management. However, there is little authoritative guidance on what taking part in the management of the partnership business means. As a result, there is a degree of uncertainty as to what a limited partner of a UK limited partnership may do without jeopardising its limited liability status.

The Government proposes introducing a 'white list' of activities that a limited partner of a 'private fund limited partnership' may perform without jeopardising its limited liability status. The list is drafted broadly and covers activities such as approving or vetoing investments, as well as more mundane limited partner involvement (e.g., approving accounts, appointing or nominating a person to represent the limited partner on the private fund's advisory committee and taking part in a decision in respect of a potential or actual conflict of interest).

Respondents to the consultation suggested a number of additions to, and modifications to the detail of, the list of activities constituting the 'white list'.

The Government has determined there is a strong case for clarification in relation to 'look-through' voting for a UK limited partnership established to operate as a feeder fund. The Government also took heed of the BVCA's recommendation that the 'white list' should be expressed to be non-exhaustive, so as to avoid giving rise to an adverse presumption about activities that are not included on the 'white list'.

(C) Capital contributions

The proposed reforms in respect of capital contributions draw a distinction between a 'private fund limited partnership' established following the implementation of the reforms and a UK limited partnership established before the implementation of the reforms and that subsequently elects to be designated as a 'private fund limited partnership' (a "pre-existing UK limited partnership").

Broadly, the proposed reforms involve the abolition of:

- the requirement for a limited partner of a 'private fund limited partnership' to contribute capital to that limited partnership, although this change will have no practical impact on pre-existing UK limited partnerships. Currently, an investor must contribute capital on its admission as a limited partner of a UK limited partnership in order to secure its limited liability status (i.e., capital must be drawn down from or advanced on behalf of an investor concurrently with its admission); and

[11] As defined in Part 17 of the Financial Services and Markets Act 2000..

- the restriction on a limited partner of a 'private fund limited partnership' withdrawing capital contributed to that limited partnership during the life of that limited partnership, except in respect of a pre-existing UK limited partnership and then only to the extent of capital contributions made prior to implementation of the reforms. Currently, a limited partner of a UK limited partnership that withdraws capital contributed to that limited partnership during the life of that limited partnership will be liable for the debts of that limited partnership up to the amount of capital withdrawn.

(D) Registration and on-going notification requirements

The consultation proposed a simplified registration process for 'private fund limited partnerships', with a reduction in the amount of information that has to be included in an application for registration (or following a change in the particulars) when compared with what is currently required for a limited partnership. For example, the amount of a limited partner's capital contribution would no longer have to be notified, except in respect of a pre-existing UK limited partnership, where capital contributed prior to implementation of the reforms will still be recorded on the public register. This proposal would also reduce the amount of information about a 'private fund limited partnership' that is made available to the public.

In addition, the proposals provide for the abolition of the requirements under the 1890 Act and the 1907 Act to advertise publicly certain changes to a 'private fund limited partnership'. Currently, an advertisement must be placed in the Gazette if, for example, a limited partner of a limited partnership assigns any portion of its interest in that limited partnership to another person. This requirement will be removed as part of the reform package, although the requirement to advertise a notice in the case of a general partner becoming a limited partner will remain.

(E) Winding-up

The consultation proposes that the partners of a 'private fund limited partnership' be allowed to agree who is responsible for winding up that limited partnership. Currently, it is prescribed that the general partner of a UK limited partnership must wind up that limited partnership, unless the limited partners obtain a court order to the contrary. The default position would still be that the general partner is responsible for the winding up of a 'private fund limited partnership' except where there is no general partner (e.g., following its removal at the election of the limited partners), in which case the default position would be that the limited partners would appoint a third party to wind up the 'private fund limited partnership' (with such power of appointment expressly referenced in the 'white list'). However, it is proposed that the partners be allowed to agree otherwise.

(F) Duties of limited partners

The consultation proposes that the existing statutory duties to render accounts and information to other limited partners and to account for any profit derived from a competing business (i.e., sections 28 and 30 of the 1890 Act) do not apply to limited partners of a 'private fund limited partnership', unless agreed otherwise by the partners.

Reforms not being pursued

(A) Separate legal personality

There is one notable reform recommended by the BVCA that HMT did not consult on – the possibility of an English limited partnership being allowed to elect for separate legal personality. HMT considered that further work is needed to explore the implications of, and legislative changes required to effect, such reform. The BVCA will continue to press HMT to implement this change, which we continue to believe is a sensible and important reform.

(B) Public register strike-off procedure

As part of the package of reforms the Government consulted on, the Government proposed introducing a procedure for removing 'private fund limited partnerships' from the public register – with the primary purpose of creating an up-to-date register that records only 'private fund limited partnerships' existing from time to time.

The BVCA, and a number of other respondents to the consultation, raised concerns about the register strike off procedure that was contemplated in the consultation, particularly as to its potential impact on the limited liability status of limited partners of a UK limited partnership incorrectly struck off the register. As a consequence of these concerns, the Government has withdrawn its proposal to implement a register strike-off procedure.

Next steps

The stated goal is that the changes to UK limited partnership law will be fully operational by March 2017.

9. The end of CRC...

Doug Bryden

Travers Smith

The UK's Carbon Reduction Commitment Energy Efficiency Scheme ("CRC") has been a thorn in the side of many private equity houses and their advisors, requiring complicated grouping analysis, additional and often expensive technical consultancy support and then the headache of cost allocation and recovery. So, at first glance, the UK Government's announcement that it intends to abolish CRC and create a new single business energy tax, is a welcome relief. However, the industry should be careful as the benefits of the latest set of reforms to the UK's business and energy efficiency landscape are neither as immediate nor as clear cut as hoped.

One important point to note is that the Government will not be losing the revenue generated by CRC. Although these changes are trumpeted as being for the benefit of UK businesses, the reality is that the CRC is equally cumbersome and expensive for the Government - one may cynically say that the real winner from these reforms will be the Government: the same revenue, but collected at a fraction of the cost.

Background to changes

The upcoming raft of regulatory changes in this area follows the Government's 2015 consultation on 'Reforming the Business and Energy Efficiency Tax Landscape' (the "2015 Consultation"). In the 2015 Consultation, the Government stated that the number and complexity of business energy efficiency taxes and reporting requirements made compliance for UK businesses difficult and discouraged increasing energy efficiency and carbon reduction. As a result, the Government has proposed simplifying compliance procedures through the creation of one tax and reporting scheme. Although such industry friendly sentiment and desire for simple, clear policy is to be welcomed, the Government's current stance fundamentally misses the point of CRC and what it seeks to achieve. That said, these changes can only be seen as positive for UK business and private equity.

What should we expect…

The Government published its full response[12] to the 2015 Consultation in the 2016 Budget and is examined in greater detail below:

Abolishment of CRC

As discussed above, the most significant reform contained in the response to the 2015 Consultation was the announcement of the closure of CRC. The abolishment of CRC will be effective from the end of the 2018-2019 compliance year.

Creation of a single energy tax

A new single business energy tax is to be created. This will be based on the current Climate Change Levy ("CCL").

From April 2019, the CCL rates on taxable energy supplies will increase as a 'fiscally-neutral' means of recouping the revenue lost from the abolition of CRC. Between now and April 2019, the CCL rate will only increase in line with RPI.

The Government has stated that the current CCL exemptions available for small businesses will remain in place. Additionally, the CCL discount available to Climate Change Agreement participants (entities with a voluntary agreement made with the Environment Agency to reduce energy use and carbon dioxide emissions) will also increase from April 2019.

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12 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/508159/reforming_business_energy_efficiency_tax_response_final.pdf

Increased energy efficiency reporting

The response to the 2015 Consultation did not discuss how the energy efficiency reporting function of the CRC would be replaced. Accordingly, the Government now plans to launch a new consultation in summer 2016 to consider a ‘simplified energy and carbon reporting framework’ for introduction by April 2019 (the “2016 Consultation”).

The specific reporting obligations for ‘qualifying organisations’ that will be considered in the 2016 Consultation remain to be seen. However, the Government has stated that the framework will be designed through the ‘prism’ of the Energy Savings Opportunity Scheme and is likely to consider (i) the criteria for determining a ‘qualifying organisation’, (ii) the amount and type of data to be collected and (iii) the subsequent annual reporting obligations (which may require either board or senior management sign-off or public disclosure of data).

Legacy of CRC for private equity

The abolition of CRC and consolidation of overlapping energy efficiency policies and regulations will undoubtedly simplify the position for the private equity industry. From 2019, GPs, funds and portfolio companies will no longer need to gather and report on data and then buy and surrender requisite CRC allowances. Likewise, the need to assess the nature and extent of fund and corporate structures to determine groupings for the purpose of CRC compliance will be a thing of the past. Or will it? One of the unfortunate legacies of the CRC is the targeting by UK policy makers and legislators of corporate groups rather than simply looking at individual entities or facilities. The proliferation of this approach in financial, environmental and other regulatory regimes will pose a continuing burden for private equity. However, at least the industry and its advisors have now developed a better understanding of how to approach such grouping analysis.

Conclusion

Although the administrative burden of CRC will be removed, the new CCL imposed on taxable sources of energy from April 2019 will negate any financial benefit of the abolishment of CRC. Additionally, the planned changes to the energy efficiency reporting requirements are likely to create some ongoing administrative challenges.

There is little doubt that the Government’s reform of business and energy efficiency policies is a positive development. However, the CRC will still be around for a few more years and be seen by many as ushering in a new regulatory focus on group structures.

10. EU audit reform and the impact on the private equity industry


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Jane Fowler
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In April 2014 the European institutions issued Regulation EU/537/2014 and Directive 2014/56/EU covering specific requirements regarding the statutory audit of public interest entities ("PIEs") and the statutory audit of annual and consolidated financial statements. The directive and regulation come into effect on 17th June 2016.

What is a PIE?

PIEs are defined as:

a) entities governed by the law of an EU Member State whose transferable securities are admitted to trading on a regulated market in the EU;

b) credit institutions i.e. businesses which are able to take deposits or other repayable funds from the public and to grant credits for its own account;

c) insurance undertakings i.e. businesses regulated to undertake insurance business, such as life, general, reinsurance and permanent health, excluding insurance brokers; or

d) entities designated by Member States as PIEs, for instance, undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees.

Applicability to the private equity industry

The UK Government has not taken the Member State option to designate additional entities as PIEs. We will need to monitor how the directive is implemented across different Member States to fully assess the impact on the industry. For example, when the reforms were first proposed, alternative investment funds were included in the definition of a PIE. This clearly would have been disproportionate and costly in the context of the impact of the key provisions discussed below.

PE-backed companies frequently have debt listed on *non-regulated markets* such as the Channel Islands or Luxembourg. Listed debt on a regulated exchange is less frequent, but not uncommon. Similarly, a partial IPO is an increasingly common feature of PE firms' planning for exits.

Given the possibility for portfolio companies in a fund, the fund itself and the general partner ("GP") of the fund to be covered by the directive and regulation (see more below), the BVCA engaged with policymakers as the proposals were developed. Our primary focus has been to ensure members continue to have choice when selecting advisors given the potential for multiple firms to be conflicted out of engagement as a consequence of how the group rules interplay with fund structures and the transactional nature of the industry. In the UK, the BVCA successfully lobbied during the transposition stage to ensure PIEs did not include listed debt on non-regulated markets.

What is the impact of the reform?

The key provisions are:

- Mandatory firm rotation

  The audit term of PIEs is limited to ten years, although a second term of ten years can be applied if the audit is tendered after the initial ten year term.

- Audit committees

  All PIEs are required to have an audit committee, unless exempt by virtue of their size. Additionally, the committee as a whole should have competence in the sector, with at least one member of the committee having competence in audit/accountancy, and the majority of the committee being independent of the entity.

- Provision of non-audit services

  The auditor and any member of their network will be restricted in both the quantum and type of non-audit services it can provide to the PIE, any EU registered parent and their EU controlled undertakings. The significance of the impact of the restrictions will critically depend upon the domicile of the PIE (as local Member State law applies), and a number of other structural matters.

Prohibited non-audit services

The auditor of a PIE, or any member of the network to which the audit firm belongs, will be unable to provide certain prohibited non-audit services to the PIE, as there are considered to be no safeguards to the auditor's independence if providing these services. Prohibited non-audit services include:

- Certain tax services such as preparing tax forms, payroll tax, calculation of direct and indirect tax and deferred tax, and the providing of tax advice
- Services that result in decisions on behalf of management[13]
- Bookkeeping and preparing accounting records and financial statements[13]
- Payroll and certain HR services
- Designing and implementing internal control/risk management procedures in relation to financial information[13]
- Valuation services
- Certain legal services
- Services related to the internal audit function
- Promoting, dealing or underwriting shares in the audited entity

This prohibition extends across the group **to a parent or a controlled undertaking of the EU PIE**. Per the directive and regulation, this only takes effect within the EU, so any parent or controlled undertaking outside of the EU will not affected by the prohibitions. However, for **auditors of UK PIEs**, the prohibition of the non-audit services to controlled undertakings **does apply outside the EU**. Nonetheless auditors of PIEs in other member states will need to assess the threat to their independence as a result of non-audit services provided to group undertakings by their network members in non-EU countries.

Permitted non-audit services

The auditor of a PIE will be able to provide permitted non-audit services (i.e. those which are not in the list above), but these will be subject to a cap of 70% of the audit fee. Permitted non-audit services are services which do not have a direct effect or have a clearly inconsequential effect on the financial statements.

It is expected that certain transaction-related services typically required by PE firms, such as acquisition due diligence, will be permissible (although this will depend on the specific scope of the services provided). Therefore, the audit fee cap becomes important when assessing relationships with advisors. The cap is calculated as the current year non-audit fees billed by the PIE's auditor (excluding fees for services that must be provided by the auditor by law e.g. interim reviews and reports to the regulator) divided by the three year average audit fee.

The application of the three-year average audit fee is forward-looking and, as the calculation relies on there being an average of three years' statutory audit fees, the cap will come into effect for accounting periods commencing on or after 17th June 2019.

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[13] Similar provisions already prevent these non-audit services from being provided by auditors per the IFAC Code of Ethics

As above, this restriction will apply to non-audit services delivered by the auditor to both the PIE itself and its parents or controlled undertakings. In the UK, this has been extended by the FRC to apply to non-audit services also provided by firms within the auditor's network, both in the EU and **outside the EU**. Firms will need to consider whether other member states will also extend the application of the cap on permitted non-audit services to firms within the auditor's network, and/or outside the EU.

The statutory auditor/audit firm may request, on an exceptional basis, that the FRC allow the cap on non-audit fees to be lifted for no more than two years. Should the cap be breached, the auditor will be prevented from accepting appointment for the financial period in question or from signing the audit report, if they had previously accepted reappointment.

Is the General Partner considered to be the parent of a PIE portfolio company?

The application of the directive and regulation extends to all 'parent undertakings' incorporated in the EU. Whether a GP of a PE fund is a parent undertaking is a complex and fact-specific area.

GPs are typically minority shareholders of the funds they manage, so whether they are considered to be a parent depends on the level of control it has over the fund. If it is viewed to control the PE fund, the GP would be considered to be the PE fund's parent and thus the parent of the PIE portfolio company. Various factors affect whether a GP has control over the fund, such as the powers conveyed to the GP by the limited partnership agreement, or the existence and potential to exercise a no-fault divorce clause. Where the powers conveyed to a GP are limited, or Limited Partners can exercise a no-fault divorce clause and remove and replace GPs, the GP may not be considered to have control over the fund and so may not be viewed as a parent. PE firms will have reviewed this matter for other pieces of legislation and should refer to that analysis.

Will an investment advisor procuring non-audit services be subject to the requirements?

Many PE houses also have an investment advisor, which may be a member of the same legal group as the GP, or may be a separate legal entity, albeit with many common shareholders. An assessment of whether the investment advisor is in a control relationship with a PIE should be carried out.

Where an investment advisor is not in a control position and therefore not included in the PIE's group, an assessment must be made as to whether the provision of a service to an investment advisor could constitute an indirect provision of a service to an entity within the PIE group.

For example, where an investment advisor commissions a valuation of a 'sister' portfolio company to a PIE portfolio company (i.e. the portfolio companies are owned by the same PE fund and controlled by the same GP) and passes this to the fund, with no interpretation, further work or analysis, the service is deemed to have been provided indirectly to the fund. In such circumstances, the services would be subject to the non-audit service restrictions per the regulation.

On the other hand, in the above example, were the investment advisor to obtain a valuation for its own purposes, in order to provide its own advice to the fund (having performed further work, analysis or interpretation), it would be unlikely that the service could be considered an indirect service to the fund. However, if the fees for the service were (re)chargeable to the fund/parent undertaking it could be reasonable to assume that the service was provided indirectly. Careful analysis is required here to assess whether the investment advisor is covered by the restrictions.

What should firms be doing?

With the requirements coming into effect for accounting periods commencing on or after 17th June 2016, PE firms should start to consider the implications for them by:

1) Assessing whether there is a PIE or PIEs within their current structure and identifying the relevant auditor (note that many Member States have not implemented the directive so may extend the definition of a PIE);

2) Undertaking or reviewing existing analysis on which entities are impacted in the fund structure i.e. identifying parent undertakings (including potentially the GP) and controlled undertakings;

3) Determining which non-audit services cannot be provided by the auditor of the PIE and reviewing alternative arrangements;

4) Considering whether an investment advisor in their structure will be able to procure non-audit services from the relevant audit firm;

5) Estimating the three-year average of audit fees to plan for the cap on permitted non-audit services and reviewing alternative arrangements; and

6) Assessing how the EU rules operate alongside other restrictions a PE firm may have e.g. SEC requirements.

The BVCA has been working with the European Contact Group ("ECG") which is preparing guidance and monitoring the implementation of the directive across the EU (as not all EU countries have done this to date). This note will be revisited when the ECG's work is published and more Member States have implemented the directive (to assess if there has been any gold-plating).

11. Case law round up 2015/2016

Dorothy Murray

King & Wood Mallesons

Matthew Wild

King & Wood Mallesons

Relief for managing partners: multi-party LLP Agreements are not terminated by repudiatory breach

Flanagan v Liontrust Investment Partners LLP [2015] EWHC 2171 (Ch)

The normal contractual rule is that where one party commits a sufficiently serious breach, the innocent party may accept that "repudiatory" breach, terminating the contract and claiming damages. The English Court considered whether the same rule applies to LLPs and concluded that it does not (save possibly where the LLP has only two members – left open for another day). This position follows that of general partnerships but had not been considered by a court before.

The fund manager claimant was a member of the LLP pursuant to an LLP Agreement. The LLP tried to remove him but served invalid termination notices and committed other breaches of contract. He asserted that when he accepted these breaches, the LLP Agreement terminated such that the default rules contained in the LLP Regulations 2001 applied (and he was, fortuitously, entitled to an equal share of the equity rather than his annual fixed profit share).

If the repudiatory breach doctrine applied to LLP Agreements, the Court held, it would leave the member(s) accepting the breach subject to the default rules *vis a vis* the LLP and the others still subject to the LLP Agreement. Parliament cannot have intended such a mess. Accordingly, the Court concluded that the statutory scheme for LLPs must implicitly exclude the RB doctrine and that where, as here, the LLP Agreement expressly excluded the default rules, it would be "*offensive to common sense and contrary to the reasonable expectations of the parties*" to allow otherwise.

A common argument by claimants in LLP disputes may have been removed, but some uncertainties remain as regards two member LLPs, and whether the rule may also be excluded in relation to other multi-party contracts.

Tip: Don't breach the LLP Agreement when trying to remove a member. This first instance decision left a number of situations open for a different interpretation, especially as leading textbooks in the area reach a different conclusion!

An important reminder for company directors: UK Supreme Court confirms powers must be exercised for a "proper purpose"

Eclairs Group Ltd and Glengary Overseas Ltd v JKX Oil & Gas plc [2015] UKSC 71

The Board of LSE listed oil and gas company JKX exercised its power to impose voting restrictions on two of JKX's major shareholders, Eclairs and Glengary, after it considered they had failed to answer disclosure notices about their ownership of JKX.

The court found that the Board's primary purpose, however, was not to elicit the information sought, but to influence the outcome of the AGM, due to take place in two days' time and at which it was known that the shareholders intended to oppose various resolutions.

The Supreme Court confirmed that the rule set out by section 171 of the Companies Act 2006 - that directors must only exercise powers for the purpose conferred - was of general application. Acts must be within the scope of the power and for a proper purpose or motive (which could be express or implied from context). The rule is fiduciary and is therefore applied strictly; in particular, the court rejected the argument that the shareholders could have complied with the disclosure notice to avoid the penalty. The exercise of the power here was for an improper purpose, and the restrictions could not stand.

Tip: When exercising a fiduciary power, a company director should always consider whether the purpose for which the power is being used is consistent with the purpose for which it was given to the directors.

The rule against penalties is a narrow one; courts will take a commercial view of "legitimate interests"

Cavendish Square Holding BV v Talal El Makdessi [2015] UKSC 67

This case may be familiar to regular readers as it has featured in a number of previous bulletins. In brief summary, the parties agreed to sell the majority shareholding in a marketing company. The share purchase agreement contained non-compete covenants, which the Seller admitted to breaching. The Buyer relied on contractual provisions requiring the Seller to sell the remainder of his shares at a price without reference to goodwill, and allowing Buyer to withhold two instalments of the purchase price. The question for the court was whether these provisions were penal in nature and therefore unenforceable?

The Supreme Court upheld them as valid and enforceable. They said that the distinction between "genuine pre-estimates of loss" - the traditional articulation of the test for an enforceable contractual provision which sought to pre-determine the consequences of a breach – and "penalties", which would be unenforceable, was too simplistic. The real questions should be whether there is a legitimate interest to be protected (and such interests were not limited to compensation), and whether the clause is out of all proportion to the legitimate interest – in other words, is it unconscionable or extravagant? All the judges agreed that the Buyer had a legitimate interest to protect by ensuring compliance with the non-compete covenants - the goodwill of the business being crucial to the value of the company. Commercial parties of equal bargaining power are presumed to be the best judges of the appropriate consequences of a breach of their agreement.

The majority of judges considered that the penalty issue did not even truly arise on the facts. The question can only be asked of a secondary obligation; that is, one triggered by a breach of contract. The clauses here were properly understood as primary obligations in their own right: a price adjustment clause and a share option, which together reflected the price to be paid for the business absent the Seller's loyalty.

In the joined appeal – was a £85 charge for overstaying in a car parking space an unenforceable penalty? – the Supreme Court dashed the hopes of motorists across the nation. The car park operator had a legitimate interest to protect (a rational parking management scheme) and the level of the charge was not "extravagant" or "unconscionable".

Tip: Protection of goodwill is a common concern in M&A and in equity documents. Clear and careful drafting can avoid the penalty rule altogether - think "primary obligation" and "legitimate interest".

Draft it properly in the first place: the trend towards "purposive" interpretation of contracts has its limits

Wood v Sureterm Direct Ltd v Capita Insurances Services Ltd [2015]

The parties disagreed whether an indemnity in a share purchase agreement covered compensation paid out by the Target as a result of it self-reporting to the FSA. The Buyer argued that the Seller's interpretation lacked commercial common sense. The Court of Appeal emphasised that the first step to ascertain the intentions of the contracting parties was to look at the plain meaning of the words. Where these were clear (as the Court of Appeal considered them to be here after detailed consideration of the language used) this was also the last step. The fact that such interpretation was a poor deal for the Buyer did not mean that "commercial common sense" trumped the words actually used. Contracts are the result of negotiation and compromise; courts should be wary of re-drafting the parties' deal and letting a party out of a bad bargain.

Tip: Think carefully before incurring the cost of litigating a clause where the plain words used do not support your case. The courts are unlikely to rescue you.

… But if the words used are ambiguous, the courts will look for the most commercially sensible interpretation

Nobahar-Cookson & Ors v The Hut Group Ltd [2016] EWCA Civ 128

Faced with a clause in a share purchase agreement (which set a limited period for the Buyer to give notice of a warranty claim) that could mean one of three things, the Court of Appeal could find no clear solution, either on the plain meaning of the words used or when understood in the relevant context. The most commercially sensible interpretation was therefore preferred. One judge commented that if a purposive approach had still yielded no clear answer, then the "contra preferentem" rule could have been applied. That is, to interpret the clause against the party seeking to limit the exercise of the right; parties being assumed to use clear language if seeking to limit remedies provided by the law. This was not necessary, however, on the facts here.

Tip: There is no substitute for clear drafting at the outset, but if the contract isn't clear it may be worth litigating if you have commercial sense on your side, or the other party is seeking to limit your remedies.

Check it once, check it twice, check it again: The devil is in the detail when it comes to notifications

Tesco UK Ltd v Aircom Jersey 4 Ltd

This decision provides a pertinent reminder of the need to strictly comply with notification requirements when seeking to enforce contractual rights. Here, the Buyer sought to enforce certain seller warranties under a share purchase agreement (SPA) which contained notification requirements. The notification requirements were not atypical – the Buyer was required to provide reasonable details of the claim (including the grounds on which it was based and the Buyer's good faith estimate of the amount) as soon as reasonably practicable after becoming aware of the claim – however the notices served were found to be ineffective due to non-compliance with the terms of the SPA. The Buyer was therefore out of time to make its warranty claims.

Tips: make it clear that a claim is being made rather indicating that one may be made; clearly state that the notice is being given pursuant to and for the purposes of the relevant clause(s); specify which warranties and / or indemnities under which the claim(s) is being made; and observe the temporal requirement.

An obligation to use reasonable endeavours and / or to act in good faith can be curtailed by other more detailed specific contractual conditions

Bristol Rovers (1883) Limited v Sainsbury's Supermarkets Limited [2016] EWCA Civ 160

Sainsbury's agreed to buy Bristol Rovers' stadium site, completion being conditional on Sainsbury's obtaining planning permission allowing 24 hour deliveries. Planning permission was granted but subject to onerous restrictions. The contract required Sainsbury's to appeal, but only if certain conditions were met. After an unsuccessful appeal, Sainsbury's sought to terminate the conditional agreement and refused to allow Rovers to launch a planning appeal in its own name. The Court of Appeal upheld Sainsbury's position: where it was not required to appeal itself, the parties cannot have intended it would be required to consent to Rovers filing its own application. Rovers sought to rely on Sainsbury's contractual obligations to use "all reasonable endeavours" to obtain the planning permission and to act generally in good faith. These obligations however were to be read subject to the specific obligations in relation to appeals.

Tip: It is usually a good idea to specify quite clearly (but without limitation) things you will not be required to do in order to meet a reasonable endeavours obligation, and these will trump the more general wording used.

Information you gather might end up before the court: the scope of litigation privilege is not as wide as people might think

Property Alliance Group Ltd v RBS Plc [2015] EWHC 3341 (Ch)

PAG met with two ex-employees of RBS to gather evidence for their swap mis-selling claim. They claimed that recordings and transcripts of these conversations were subject to litigation privilege, and not therefore disclosable to the other side as part of the normal litigation discovery process. Litigation privilege protects communications between parties and their solicitors and third parties for the purpose of obtaining information or advice in connection with existing or contemplated litigation. As part of this standard, PAG must show that the communication was for the sole or dominant purpose of conducting litigation. The Court said this is an objective test. PAG did not tell the individuals their purpose (to gather evidence); instead they thought that the meeting was to discuss future business opportunities. Where one side of the meeting had been actively misled in its purpose by the other, it was not possible to distil any dominant purpose from the meeting. Although PAG procured the creation of the documents in question, the Court was not willing to prefer PAG's purpose given the deception. There was no litigation privilege.

Tip: Take care when seeking information to support your case. Failure to explain your intentions may result in a lack of the "dominant purpose" necessary to assert privilege over material created.

International agreements

Arrêt n° 1053 du 7 octobre 2015 (14-16.898) - Cour de cassation - Première chambre civile - ECLI:FR: CCASS:2015:C101053

One-sided jurisdiction clauses, where one party has a choice of courts in which to bring a claim but the other party does not, are enforceable in England, but a recent controversial decision in France refused to uphold them (Mme X v Rothschild). The French courts have reconsidered the issue and upheld a clause where the choice of courts was not unlimited but was to a defined list of jurisdictions. The outlook for such clauses in France and other civil code jurisdictions improves, albeit only with the right drafting.

Hague Convention on Choice of Court Agreements – recognition and enforcement of judgments

The enforceability of judgments of a court having jurisdiction by reason of exclusive jurisdiction clauses is to be significantly improved by The Hague Convention on Choice of Court Agreements. Currently only in force as between the EU and Mexico but with Singapore soon to join too, reports are that it is gaining international traction. It does for choice of court agreements what the New York Convention does for arbitration agreements – make those agreements and judgments/awards arising from them easily enforceable.

Micula, Viorel Micula and others v Romania (ICSID Case No. ARB/05/20) – bilateral investment treaty protection / state aid tension

Take note if investments in the EU have been structured to take advantage of the protection of bilateral investment treaties. The Micula brothers succeeded in a treaty claim against Romania, but the European Commission determined that payment of the €8 million plus award contravened EU state aid laws. Tension and contradictory rulings ensued and continue.

12. The Walker Guidelines – Remaining Relevant in the Age of Transparency

Sundip Jadeja

BVCA

Next year marks the 10th anniversary of the publication of Guidelines authored by Sir David Walker, aimed at increasing transparency across the private equity industry. This was on request of the BVCA and amidst increased public scrutiny and negative publicity faced by the industry. One of his recommendations was the creation of an independent body, the Private Equity Reporting Group (PERG), originally known as the Guidelines Monitoring Group, to monitor compliance by the largest private equity firms and their portfolio companies with the Guidelines. Today the Guidelines and PERG continue to play a key role in enhancing transparency across the private equity industry, whilst also helping to improve the understanding of the contribution made by the asset class to the UK economy.

The need for transparency

Transparency has remained a central theme of political and social discourse in recent years, ranging from the implementation of the pubic register of people with significant control over UK companies to the Modern Slavery Act last year, and the wide-ranging efforts by governments around the world to improve financial transparency through the OECD and other organisations. In a similar vein, there has been an increasing expectation for nominally private companies to disclose greater information akin to quoted firms. Indeed, for private equity, remaining entirely 'private' is no longer acceptable, as it continues to occupy a public presence in the economy and wider society, for example through its acquisition of large 'high-street' names.

The Guidelines have played an important role in representing the industry, addressing public suspicion of private equity and promoting the industry's importance to the economy. It is clear that private equity as an asset class is more likely to prosper if the industry has a positive image and support from stakeholders such as employees, suppliers, regulators and legislators.

The Guidelines' requirements

Portfolio company disclosures

The Guidelines cover the largest portfolio companies with a strong presence in the UK. Due to their size and significance, portfolio companies are required to make certain disclosures in their annual reports, in line with equivalent quoted companies, with disclosures benchmarked against FTSE 350 companies. Like quoted companies, portfolio companies are also required to publish their annual reports within 6 months of their financial year-end and on their website.

Aside from Guideline specific disclosures, such as identifying the PE owner and details of board composition, portfolio companies are required to make disclosures which have been adopted from Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 (the Strategic Report regulations), which apply to quoted companies. These include disclosing an analysis of development and performance during the year; the company's strategy, principal risks, and financial and non-financial key performance indicators; and matters regarding the environment, employees, social and human rights issues, and gender diversity.

Performance of portfolio companies

Data is collected and published annually on the performance of portfolio companies, which supports the advocacy work the BVCA does on behalf of the private equity industry. It gives us the credibility needed when discussing the industry's contribution to the broader economy in terms of employment, productivity and growth, as benchmarked against equivalent quoted companies. It also provides a returns attribution analysis which quantifies the impact of strategic and operational plans implemented under private equity ownership, as well as the impact of leverage.

PE house disclosure

In order to increase the transparency of the private equity houses that control the portfolio companies in question, the Guidelines require a range of disclosures by these firms on their website or annual report. This includes an indication of their general investment approach (including hold periods), identification of the senior leaders of their UK operation, descriptions of other UK-based portfolio companies they own, and categorisations of their limited partners (by geography and type).

The future of the Guidelines

One key advantage of the Guidelines is their flexibility and proportionality compared to formal regulation, and their ability to evolve quickly in response to a dynamic and fast-moving industry. Alongside monitoring compliance with the Guidelines, the PERG also regularly reviews and, as necessary, develops updates to ensure that they remain effective and relevant.

In 2015, the Guidelines adapted the Strategic Report regulations, to ensure that the standard of portfolio company reporting was in line with quoted companies. Going forward, the PERG will review the transposition of the EU Non-Financial Reporting Directive into UK law, which is expected to amend narrative reporting, with key changes expected in relation to anti-corruption and bribery matters.

The ability of private equity to continue to invest in innovative companies, support growth and create employment, whilst delivering superior returns in a sustainable manner, is increased, rather than hindered, when the industry is able to command confidence in the way it conducts its business. By ensuring the industry remains sensitive and attentive to the interests of stakeholders, and in demonstrating the positive impact private equity has on the UK economy, the Walker Guidelines continue to be an effective tool in the broader efforts of the BVCA to promote the industry.

13. BVCA template "Request for Proposal for provision of Fund Administration Services"

Sophie House

BVCA

The BVCA periodically releases industry documentation and guidance in the UK and the feedback we have received on our model documents projects thus far has been encouraging. In view of this, the BVCA has recently published a template "Request for Proposal" for provision of fund administration services, after a consultation over the past year. The BVCA has been working to create the standard document, together with the Legal & Technical Committee and a number of fund administrators active in the UK private equity industry.

The template was created to provide the industry with detail on the nature and depth of information which could be requested from fund administrators during a tender process. The BVCA set up a working group which has compiled an accessible, non-exhaustive list of questions for reference and the process involved representatives from the Legal & Technical Committee, Ipes, Sanne Group and Capita Asset Services, and a huge thanks is owed to them for their hard work in producing the template. In addition, a wider group of representatives from fund administrators was involved in the feedback process. The template is intended for managers when undertaking an administrator selection exercise and should also create efficiencies in the process as fund administrators have been involved in the development of the template.

The template, which can be viewed and downloaded from our website[14], is a comprehensive catalogue which covers: details of the administrator, ownership structure, organisation and governance, size of operation, client relationship management, operations, fund accounting systems, reconciliations, reporting, internal controls audit, operational risk, business continuity/disaster recover & cyber security, general matters, regulatory status, references and fees. However, this is by no means an exhaustive list and the template will need to be tailored by managers to fit their specific requirements and, similarly, it should be stressed that not all questions will necessarily be relevant for every mandate, and users of the document are advised to delete questions which they do not regard as necessary.

[14] http://bvca.co.uk/ResearchPublications/Publications/StandardIndustryDocumentsandGuidance.aspx