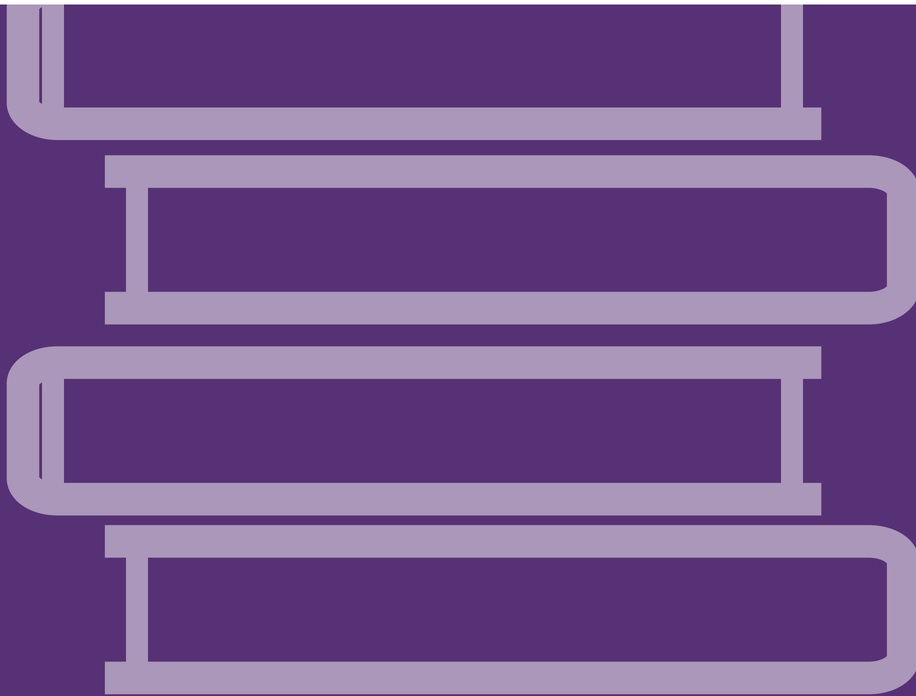
BVCA

British
Private Equity &
Venture Capital
Association



Technical Bulletin

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

November 2017 ////

Contents

BVCA

Regulatory

Legal & Accounting

Taxation

Terminology

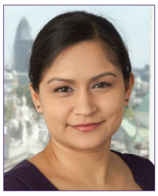
Introduction

Welcome to the BVCA Technical Bulletin, a collection of in-depth articles by members of the BVCA and our three technical committees: Regulatory; Legal & Accounting; and Taxation. Our goal is to keep BVCA members informed of the key topics on the committees' agendas, how 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.

Amy Mahon
Chair, Legal & Accounting Committee

Tim Lewis
Chair, Regulatory Committee

Mark Baldwin
Chair, Taxation Committee



Gurpreet Manku
Assistant Director General & Director of Policy, BVCA

The uncertainty surrounding the upcoming Brexit negotiations continues to dominate the BVCA's workload, and this has been further complicated by the inconclusive result of the general election in June. The BVCA's work on the key priorities for the private equity and venture capital industry and the status of the Brexit negotiations are covered in the opening article by Gurpreet Manku. Other BVCA updates include Chris Elphick's summary of the Patient Capital Review and the BVCA response to the recent consultation. This year also marks the tenth anniversary of the Walker Guidelines, and Sundip Jadeja provides a summary of the changes that have occurred, and the industry's compliance with the Guidelines, over the past decade.

The Regulatory Committee has spent time on the implementation of MiFID II and the Fourth Anti-Money Laundering Directive in the UK and responded to the FCA's final report on its asset management market study. The committee also published a MiFID II technical briefing[1] on the areas covered by the BVCA's engagement with the FCA, highlighting where the final rules contain major improvements to the original proposals regarding telephone taping, client categorisation, best execution, and inducements and research. The first regulatory article looks at the plan to extend the Senior Managers and Certification Regime to almost all financial services firms, including private equity firms, in 2018. Paul Ellison provides an overview of the main features of the regime and assesses the key impacts for private equity firms. In the second article, James Smethurst examines the European Banking Authority's proposals for a new prudential regime for investment firms and what this could mean for capital and remuneration requirements.

The Legal and Accounting Committee has responded to developments on UK corporate governance reforms. In her article, Victoria Sigeti provides an update on the BEIS response to the Green Paper, the Financial Reporting Council's set of draft amendments to its Guidance on the Strategic Report, and how they relate to privately held companies. In the case law update, Ed Griffiths gives an overview of English court judgements issued in the past six months. Tom Taylor also provides a short update on the PSC regime. Amy Mahon and Tamsin Collins examine the upcoming General Data Protection Regulation that takes effect in May 2018. Over the past six months, the committee has also made submissions on proposals to introduce corporate liability for economic crime; the post-implementation review of IFRS 13 on fair value measurement; and limited partnership reform in the UK.

The new failure to prevent the facilitation of tax evasion offence, which came in to force in September, led to a number of meetings with HMRC and corresponding workshops with BVCA members over the summer. The outcome of these workshops and the BVCA technical briefing published after the meetings with HMRC are detailed by Jennifer Wheater and Mavnick Nerwal. The ongoing OECD BEPS project has continued to be a focus for the Taxation Committee, who have responded to a range of consultations over the past two years including those covering transfer pricing, interest deductibility and treaty abuse. The last tax article by Simon Page, John Cox and Russell Warren, covers the Hybrids mismatch legislation and the BVCA engagement on the updated guidance.

The Taxation Committee has also had discussions with HMT and HMRC on a number of other topics, including disguised remuneration and the updated legislation for the close company gateway, and the carried forward loss restriction in the Finance Bill.

[1] https://www.bvca.co.uk/policy/tax-legal-and-regulatory/technical-publications/documents/MiFID-II--Technical-Briefing-

Our committee members

The BVCA is immensely grateful for the time, enthusiasm and expertise of members of the technical committees as their work is crucial to our political engagement and advocacy activities.

We would like to thank all members that have served on the technical committees, including those who have recently stepped down, for their considerable contributions. In particular, we would like to thank Sheenagh Egan who stepped down from the Regulatory Committee. Sheenagh was the most recent chair as well as a longstanding committee member, and her extensive experience and dedication has been immensely valuable to us. We would also like to welcome new members to our committees.

	New members on our committees	Members who stepped down
Legal & Accounting Committee	**Ian Roberts** (Permira) **Daniel Parker** (Synova Capital)	**Duncan Tennant** (Permira)
Regulatory Committee	**Lindsay Hamilton** (Livingbridge)	**Sheenagh Egan** (Livingbridge)
Taxation Committee	**Caroline Conder** (LDC) **Jill Hardie** (SL Capital Partners) **Federico Saruggia** (Permira) **Tim Spence** (Graphite Capital)	

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

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

With best wishes,

Amy Mahon

Chair,
Legal & Accounting Committee

Tim Lewis

Chair,
Regulatory Committee

Mark Baldwin

Chair,
Taxation Committee

Gurpreet Manku

Assistant Director General & Director of Policy, BVCA

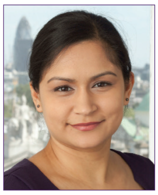
Legal & Accounting Committee	Regulatory Committee	Taxation Committee
Amy Mahon (Chair) Clifford Chance	**Tim Lewis** (Chair) Travers Smith	**Mark Baldwin** (Chair) Macfarlanes
Julie Bradshaw (Vice Chair) Doughty Hanson	**Rachel Thompson** (Vice Chair) Bridgepoint	**Abigayil Chandra** Deloitte
Alastair Richardson 3i	**Andrew Lewis** ICG	**Alexander Cox** Ashurst
Ashley Coups EY	**Babett Carrier** Cinven	**Alexandra Hone** ICG
Daniel Parker Synova Capital	**Christopher Crozier** Permira	**Anthony Stewart** Clifford Chance
Ed Griffiths DLA Piper	**Ed Kingsbury** Dechert	**Caroline Conder** LDC
Ed Hall Goodwin	**James Smethurst** Freshfields Bruckhaus Deringer	**Clare Copeland**
Garrath Marshall Deloitte	**John Decesare** 3i	**Craig Vickery** Exponent PE
Geoff Bailhache Blackstone	**John Morgan** Pantheon	**David Hewitt** Grant Thornton
Geoff Kittredge Debevoise	**Lindsay Hamilton** Livingbridge	**Dominic Spiri** Terra Firma
Graham Hislop Montagu	**Louise Dumican** Carlyle	**Federico Saruggia** Permira
Iain Bannatyne KPMG	(on maternity leave, **Matthew Cottrell** covering)	**Fiona Cooper** Starwood
Ian Roberts Permira	**Mark Howard** KKR	**Gareth Miles** Slaughter & May
John Atherton Schroder Adveq	**Neel Mehta** Mayfair Equity Partners	**Graham Iversen** Greenberg Traurig Maher
John Heard Abingworth	**Paul Cook** YFM Equity Partners	**James Pratt** BDO
Jonathan Wood Weil	**Paul Ellison** Macfarlanes	**Jenny Wheater** Linklaters
Richard Mcguire PwC	**Simon Powell** Advent International	**Jill Hardie** SL Capital Partners
Robin Bailey Pantheon	**Sarah Robinson** (secondee) Travers Smith	**Jill Palmer** 3i
Sally Roberts Accel		**John Cox** KPMG
Stephanie Biggs Travers Smith		**Jonathan Page** PwC
Trudy Cooke Terra Firma		**Maria Carradice** Mayfair Equity Partners
Thomas Laverty Kirkland & Ellis		**Matthew Saronson** Debevoise
Victoria Sigeti Freshfields Bruckhaus Deringer		**Michael McCotter** DH Private Equity
Tamsin Collins (secondee) Clifford Chance		**Paul Cunningham** Helios Investment Partners
		Paul Warn EY
		Richard Vitou Deloitte
		Russell Warren Travers Smith
		Sarah Priestley Goodwin
		Stephen Pevsner Proskauer
		Tim Hughes PwC
		Tim Spence Graphite Capital
		Tony Mancini KPMG
		William Shaul KPMG

01.

Brexit update

Gurpreet Manku, BVCA

01. Brexit update



Gurpreet Manku
Assistant Director
General & Director
of Policy, BVCA

This update includes an overview of recent developments and the BVCA's work on key Brexit priorities for our members and broader initiatives.

Timetable and negotiations

Since my last piece in the May Technical Bulletin, the UK has had a general election - where the government lost its majority – and there have been six rounds of Brexit talks with the EU. The EU implemented a phased approach to negotiations giving priority to an orderly withdrawal (and in particular citizens' rights, the financial settlement and the Irish border) before any discussion on a future UK-EU trade relationship and transitional arrangement. The hope was that this second stage of negotiations would have commenced by now but we need to wait until the EU Council meets in December. Therefore the next few weeks will be crucial, as business, including the financial services industry, has been vocal on the need to agree a transitional arrangement given the status of the negotiations.

Process of leaving the EU

The Queen's Speech in June set out the key pieces of legislation that the UK will need to implement before we leave the EU:

- The EU Withdrawal Bill – To repeal the Economic Communities Act 1972, convert EU law into domestic law and enable the terms of the exit agreement to be implemented into UK law.
- The Customs Bill – To enable the UK to levy, collect and modify its own customs duties on imported goods and to exit the EU-wide VAT regime.
- The Trade Bill – To put in place a domestic legislative framework to enable the UK to operate its own trade policy.
- The Immigration Bill – To end the free movement of EU nationals to the UK and apply a domestic migration regime to EU citizens.
- The Fisheries Bill – To enable the UK to set its own fishing quotas and access rights.
- The Agriculture Bill – To replace the Common Agricultural Policy with a domestic agricultural policy.
- The Nuclear Safeguards Bill – To establish domestic nuclear safeguards as the UK leaves Euratom, the European Atomic Energy Community.
- The International Sanctions Bill – To enable the UK to impose, update and lift its own sanctions on other countries, including asset freezes, travel bans and market restrictions.

At the time of writing this update, the EU Withdrawal Bill (formerly the Great Repeal Bill) is making its way through Parliament. Several hundred amendments to the Withdrawal Bill are under consideration including:

- when the UK will technically leave the EU and whether there should be more flexibility on this point;
- the type (and significance) of the vote MPs will get on the withdrawal agreement with the EU;
- the role of the European Court of Justice (ECJ) and the decisions it makes;
- the powers that could be returned to the devolved administrations; and
- the area getting the most attention – the powers ministers will have to amend legislation and the level of scrutiny involved.

From a BVCA perspective, we are engaging with government during this process as there is a significant amount of EU legislation, particularly regulation for fund managers, that the UK will need to amend. This is because the government cannot simply “copy and paste” EU law into the UK statute and will have to make amendments, for example where there are references to “EU law”, the involvement of an EU institution and information sharing with EU institutions. To make these changes, the government is proposing to use secondary legislation and requesting relatively wide delegated powers to do this as it is impractical to know how every law will be amended at this stage. They estimate that between 800 to 1000 statutory instruments will be needed as part of this process.

Government position papers

Over the summer, the government published a number of Brexit position papers, although the level of detail varied as this is subject to negotiation. The papers covered settlement rights for EU citizens already in the UK (which is covered in more detail in the section below) and the government’s initial thinking on trade and customs. The government has asked the EU to honour service agreements on products already sold, without additional tariffs, and urged Brussels to widen its “narrow” definition of the availability of goods on the market to include services.

The government has also set out its views on what it would do if Britain leaves the EU without striking a free trade deal. Whilst the government has repeatedly said it is planning for all contingencies, further detail on what this means from a practical perspective still needs to be put forward to give businesses the assurance they need. The customs white paper discussed provisions for the implementation of emergency customs, VAT and excise regimes in the event that “no deal” is reached. The white paper on trade indicated that the government is working on a scenario under which it could try to sign trade deals swiftly with non-EU states in the event of “no deal.” The paper did not, however, set out a detailed position. Instead it highlighted the three principles the government wants to achieve: “ensuring UK-EU trade is as frictionless as possible; avoiding a “hard border” between Ireland and Northern Ireland; and establishing an independent international trade policy”.

Other papers have covered data protection and exchange, enforcement and dispute resolution mechanisms for UK-EU agreements, and confidentiality and access to official documents.

A future trade deal for financial services

The International Regulatory Strategy Group (an industry advisory body to the City of London Corporation and TheCityUK) has published detailed proposals on the terms of a free trade agreement under which financial services suppliers in the EU and UK would have access to each others’ markets after Brexit. The proposals are intended to achieve a level of mutual access for EU and UK firms that is as close as possible to current levels. The report covers the key issue of the basis on which such mutual access might be granted and how to manage divergence in regulation in the future. It also discusses how supervision of firms could operate in the context of an EU/UK agreement and how disputes could be resolved.

This is an ambitious proposal but it is the right starting point as existing third country regimes in EU legislation do not cover the full suite of financial services or offer firms the certainty and workability they need – at least in their current form[2]. Politically, it is very unlikely that the EU will open up these existing regimes to other third countries until it is clear what the future relationship with the UK will look like.

[2] Our previous Technical Bulletins (see November 2016) covered the third country regime under AIFMD.

Industry priorities

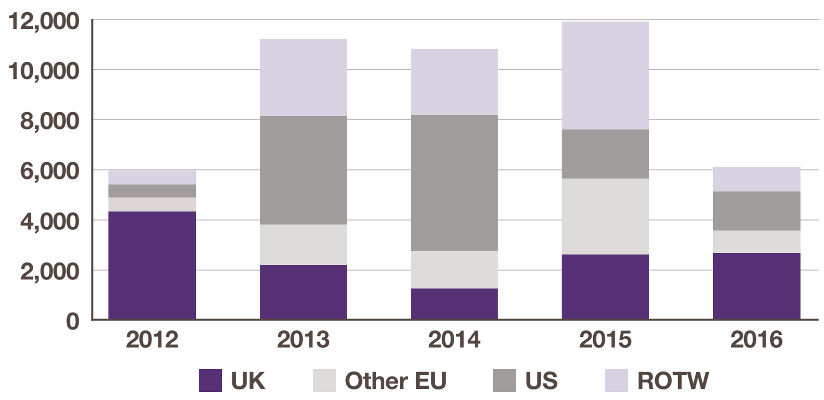
Through our discussions with the membership, we established early on that the key priorities for the UK's venture capital and private equity industry are: continued access to EU investors after Brexit; maintaining funding for the UK's venture and growth capital industry; a workable migration system, and a transitional arrangement given the tight timetable we are working within. The BVCA is continuing its engagement with regulators, government departments and ministers on these issues as part of Brexit-specific discussions as well as our ongoing work.

Investor access to UK funds

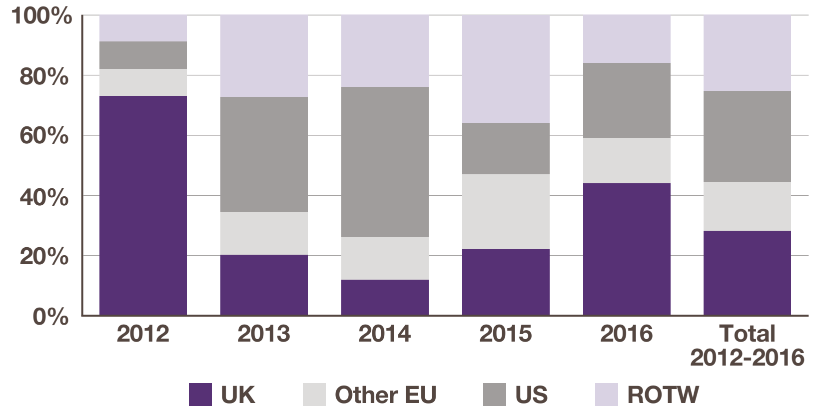
A key priority for our industry is to ensure UK firms still have access to EU investors and vice versa as the UK is the second biggest global hub for private equity and venture capital (after the US) and facilitates a significant amount of cross-border investment into Europe and the rest of the world. Our position is that European National Private Placement Regimes (NPPRs) must remain open to UK (and other non-EU) firms. This would be alongside third country access for UK firms through any new relationship with the EU.

The level of investment by EU investors into UK funds varies year on year. The BVCA collects data on our members' fundraising activity and the numbers below show funds raised from the UK, i.e. this does not include fundraising by offshore managers.

Fundraising by geography, £m



Fundraising by geography, %



The BVCA has been working with our European counterparts for a number of years on reducing the barriers to marketing to investors across the EU. This started before the leave vote, through the EU's Capital Markets Union initiative, and will continue over the next couple of years. This work covered issues with the AIFMD marketing passport and NPPRs, including differing definitions of marketing, additional notification requirements and regulatory fees, as well as the general difficulties in navigating 28 separate regimes.

The European Commission is expected to publish a legislative proposal aimed at facilitating the cross-border distribution and supervision of UCITS and AIFs in Q1 2018. This "omnibus" regulation follows an inception impact assessment the Commission launched in the summer and its March 2017 report titled 'Accelerating the capital market union: addressing national barriers to capital flows.' The report welcomes the work that Member States have undertaken to develop a common understanding of pre-marketing and reverse solicitation practices and invites them to continue reviewing their national rules, with the aim of promoting convergence in this area. In a recently published summary of the September ESMA Board meeting, the potential cliff edge effects of Brexit were discussed and the conclusions noted the "importance of ensuring consistency between national competent authorities in relation to, among others, reverse solicitation". This is an area we will therefore need to monitor as the work on the omnibus regulation progresses. Notably, this work stream will occur before any revision to AIFMD.

Funding for UK venture and growth capital funds

In recent years the European Investment Fund (EIF) has been a significant investor in UK venture, growth and mid-market funds. A key priority for the BVCA is to ensure this level of funding continues through the British Business Bank's programmes and a continuing relationship with the EIF. The government's Patient Capital Review (covered in more detail in the next article) and Industrial Strategy are the ideal platform to demonstrate the value of this additional investment to the UK economy. We have engaged extensively with government and other stakeholders on this matter, especially following reported delays in EIF investment following the triggering of Article 50 in March.

In November 2016 a further £400 million of funding was allocated to the British Business Bank which is expected to unlock up to £1 billion of new investment. At this year's Mansion House speech in June, the Chancellor of the Exchequer announced a number of measures to mitigate the impact of any possible gap left by the European Investment Bank (EIB) and the EIF. In order to maintain the flow of funding to the UK, the government will provide guarantees to the EIF in the event that the UK leaves the EU before UK managers can deploy EIF funding. At the same time, the British Business Bank has adopted more flexible investment criteria for its commercial venture capital investment programme by increasing the maximum amount it can invest in a single fund from 33% of total fund size to 50%. The Chancellor also said that "in the long-term, it may be mutually beneficial to maintain a relationship between the UK and the EIB after we leave the EU."

At the Autumn Budget 2017 the government published its response to the Patient Capital Review and we are delighted that an additional £2.5 billion has been allocated to the British Business Bank. This will support its existing programmes and a series of private sector fund of funds.

Access to talent

Being able to attract skilled individuals and entrepreneurs to the UK, as well as allowing venture capital and private equity fund managers and portfolio companies to hire the people that they need and at suitable speed, is an urgent priority. The BVCA has been in a number of conversations with government officials on why access to talent is important to the industry and the wider financial services ecosystem. We have also provided feedback on issues with current visa processes and areas to consider as part of a new migration system, such as:

- A system that reviews immigration in line with UK economic and business priorities and considers industry input when setting these priorities;
- Flexible limits for numbers of visas granted to meet needs of industries and the skills gap;
- Investing in and utilising technology to ensure the system is efficient and quicker than current processes;
- Creating a single process for all non-UK citizens, but recognising the potential for future UK free trade agreements to provide preferential access to other countries' citizens, including the EU;
- Maximising the portability of the work visa (not least to enable internal job changes/ promotions, secondments and postings without the need to revisit the employee's UK immigration status);
- Considering the impact on an individual's family, for example the employment of a spouse/partner and education of children; and
- Reviewing the opportunities for university graduates who are non-UK citizens in light of the points made above.

At the conclusion of the June summit of EU leaders, the government published proposals that would give EU citizens who have lived in the UK for at least five years "settled status". This would make them eligible for the same healthcare, pensions, benefits and education rights as British nationals. Any EU citizen who arrives in the UK before a yet to be determined cut-off date will also be given the opportunity to build up the necessary five years of residence in order to gain the new status. Family members of eligible EU citizens will also be able to apply for settled status, whether or not they are EU citizens, but they must meet the five-year residency requirement. A grace period during which all EU residents and their families will have temporary leave to remain in the UK will also be implemented on the date the UK leaves the EU. This is likely to last for no more than two years.

The Home Office has also set up email alerts that individuals can sign up to for updates. The offer, which would be overseen by British courts and is contingent on the EU offering reciprocal rights to UK citizens, received a lukewarm reception from European leaders. The EU produced its own position paper on citizens' rights at the end of May, which envisaged that any settlement would be overseen by the ECJ. UK and EU negotiations on this business-critical issue continue. At the Autumn Budget, the government confirmed it is doubling the number of Exceptional Talent visas to 2,000.

Transitional arrangements

There is clearly expected to be a period of time between the day the UK leaves the EU and the agreement of a bilateral trade deal with the EU. Therefore, a sensible transitional arrangement needs to be agreed soon to avoid cliff edge scenarios on Brexit day. The BVCA hosted a fringe event with the CBI at the Conservative Party Conference in October at which the Chancellor recognised our concerns that a transitional arrangement had to be agreed by the end of the year as it would be a "wasting asset". Further detail on contingency planning is covered below.

The Treasury Committee has also launched a new inquiry into the UK's economic relationship with the EU. The inquiry will consider a number of topics including potential transitional arrangements, preparedness for "no deal", and the effect on the long-term economic relationship. The first evidence session considered the progress of the negotiations to date, the design and governance of transitional arrangements, and the shape of the long-term economic relationship. The inquiry is expected to conclude before the end of the year.

Planning for Brexit and the impact of EU regulation

Following the leave vote, the BVCA worked with members to establish our key priorities on the assumption the UK left the EU with no special rights of access, the so-called "hard Brexit". Firms are reviewing how they manage their existing businesses in light of the uncertainty surrounding the terms of the UK exit from the EU. This entails analysing whether or not to locate part of their business in another EU Member State to ensure continued access to EU markets. This type of contingency planning is expensive and typically only available to larger managers, given the costs of seeking professional advice and scoping out potential operational changes. It may also depend on the extent to which EU access is important and as our data shows, there is a greater proportion of funds raised by our members from investors in the UK and the rest of the world than from investors in the EU. The majority of the BVCA's members are also smaller firms that may only raise funds domestically or may not be able to incur the costs related to contingency planning that is difficult to reverse. A transitional arrangement is therefore even more important for smaller firms.

The PRA has warned the government (in response to a request from the Treasury Select Committee Chair) that Brexit could destabilise the financial sector, introduce new risks and over-burden the regulators meant to manage them. This is based on a survey of 400 firms and the results show that firms are concerned about continued servicing and performance of existing contracts and restrictions on data transfer. There were also concerns about how firms will restructure themselves because of Brexit and what that means for their oversight.

The BVCA has been in regular dialogue with the FCA about how our members are planning for Brexit and the impact of developments in the EU. These developments include the opinions published by ESMA outlining general principles to support supervisory convergence in the context of the UK withdrawing from the EU. The document is directed at national regulators (National Competent Authorities/NCAs) in the EU27, and is intended to ensure regulators take a consistent approach to processing applications from firms seeking to relocate to the Continent as a result of Brexit. The first opinion set out nine broad principles that national regulators should follow when processing applications to be authorised to conduct financial services in the EU. These were:

1. No automatic recognition of existing authorisations;
2. Authorisations granted by EU27 NCAs should be rigorous and efficient;
3. NCAs should be able to verify the objective reasons for relocation;
4. Special attention should be granted to avoid letter-box entities in the EU27;
5. Outsourcing and delegation to third countries is only possible under strict conditions;
6. NCAs should ensure that substance requirements are met;
7. NCAs should ensure sound governance of EU entities;
8. NCAs must be in a position to effectively supervise and enforce Union law; and
9. Coordination to ensure effective monitoring by ESMA.

This was supplemented by sector-specific opinions on the relocation of investment firms and investment managers. The guidance on investment managers, including alternative investment fund managers, covers four key aspects: authorisation; governance and internal control; delegation; and effective supervision. The opinions are primarily intended to avoid a 'race to the bottom' whereby different national regulators compete.

ESMA has also set up a Supervisory Coordination Network with experts from national regulators that are discussing current cases involving UK firms setting up entities in the EU. In a recent speech, the Chair of ESMA explained that all information provided is anonymised and this is "the first time that competent authorities have discussed actual cases in this manner and we see it as a further step in the natural evolution of ESMA's role. While the national regulators ultimately retain their full responsibility for authorisation decisions, the new forum is an important means of information-sharing and promotion of convergent practices."

The broader asset management industry, as well as private equity, has commented on the need to maintain the current delegation model and we will need to respond to the increased scrutiny it is coming under. This includes the recent proposals from the European Commission to strengthen the role of ESMA, including granting it a role in authorising fund managers' delegation and outsourcing of activities to both EU and non-EU jurisdictions.

The competitiveness of the UK's venture capital and private equity industry

The UK has a dynamic and professional venture capital and private equity ecosystem that is growing and continues to be the second biggest hub worldwide. In our representations to government, the BVCA has highlighted the need to create the right regulatory, tax and fiscal incentives to ensure the UK remains an attractive place to set up a fund manager, invest and conduct asset management activities, particularly in light of growing competition from other EU and international jurisdictions. The UK also needs to continue to attract the best international talent at both a firm and portfolio company level.

The following areas have been covered in our detailed representations:

- Creating a stable legal and tax environment so that investors have the certainty they need to make investments over the longer term. This requires reducing the complexity and pace of fundamental changes to regulation and tax legislation.
- Simplifying the approach to the design of legislation to provide certainty for fund managers and for taxpayers. The government should also be open to reforming even recent tax changes, given the altered landscape in which the country now needs to operate, particularly those aimed at incentivising individuals to invest capital for the long term.
- The UK implemented a private fund limited partnership regime in April 2017 which has helped to improve the competitiveness of UK fund structures in light of intense competition from other countries. However, the government needs to conclude its work on its broader review of limited partnerships in a manner that does not lead to undue administrative burdens that negate the attractiveness and benefits of the new regime.
- The government will need to ensure that any new migration system considers UK economic and business priorities and seeks industry input in setting immigration priorities that reflect the skills needed. Operationally, the visa process will need to be efficient to ensure the UK remains an attractive hub for business post-Brexit.
- Bolster the scale of the UK's venture, growth capital and lower mid-market funds industry by increasing the funding available to the British Business Bank to invest in funds. At the same time, we are supportive of efforts by the government to maintain an ongoing relationship with the EIF, given its significant investment in UK funds.
- To ensure there is diversity in funding sources for UK businesses, we would also encourage the government to continue its support for the tax-advantaged venture capital schemes (EIS, SEIS and VCTs). Significant sums have been raised from retail investors through the schemes, and they have played an important role in providing a continuum of early stage funding for companies from angel investing through to venture capital.

In the Autumn Budget, the Chancellor announced that the government will shortly be publishing a comprehensive strategy – the Investment Management Strategy II. The strategy will set out the government's long-term approach to ensuring that the UK asset management industry continues to thrive and deliver the best possible outcomes for investors and the UK economy.

The FCA has launched an asset management hub, which aims to support new firms by assisting them when they apply for authorisation, throughout the authorisation process and afterwards. This is phase one of the hub and will offer new firms pre-application meetings, dedicated case officers and access to the new website portal. The FCA hopes to make it easier for firms to understand how the FCA works, make submissions, and transition from the authorisation to supervision regime. They plan for future phases to feature open days and surgeries for individual firms.

Member briefings

Our revamped Brexit Portal[3] provides members, industry stakeholders and the public with key information on: (i) the top Brexit priorities for private equity and venture capital; (ii) how to stay abreast of Brexit-related developments affecting the industry; and (iii) the BVCA's Brexit engagement with regulators, policymakers and other industries.

To coincide with the triggering of Article 50, the BVCA launched a Brexit Bulletin, a monthly online briefing on key policy and political matters. This also includes surveys on the impact of Brexit in the UK and the EU covering deal activity, fundraising, migration and fund domiciliation.

At this stage, political priorities are clearly driving the negotiations. For political analysis and commentary from our Director General, please sign up to his weekly email, BVCA Insight[4].

The BVCA continues to host member breakfasts and briefings to discuss Brexit and please feel free to contact me for further information.

[3] https://www.bvca.co.uk/Policy/Political-Engagement/Brexit-and-the-BVCA
[4] https://www.bvca.co.uk/Media-and-publications/Thought-Leadership/

02.

Financing Growth in Innovative Firms: the BVCA response to the Patient Capital Review

Chris Elphick, BVCA

02. Financing Growth in Innovative Firms: the BVCA response to the Patient Capital Review

Chris Elphick
BVCA

For the UK venture and growth capital industry, the Patient Capital Review is an important part of the government's flagship industrial strategy programme. The government is aware of the need to stimulate innovation and growth in the post-Brexit economy and emulate the culture in the US, where venture capital firms are more likely to follow their early stage investment in subsequent funding rounds than in the UK, facilitated by larger venture and growth capital funds.

Background to the review

The Department for Business, Energy & Industrial Strategy (BEIS) launched a green paper on Industrial Strategy in January 2017. As part of this process, the government also announced that it would conduct the Patient Capital Review. An industry panel, chaired by Sir Damon Buffini, was created alongside the Review to help define the key themes for the consultation phase and to provide a package of recommendations afterwards. The aim of the Review was to:

- consider the availability of long-term finance for growing innovative firms looking to scale up;
- identify the long-term root causes affecting the availability of long-term finance for growing innovative firms, including any barriers that investors may face in providing long-term finance;
- review international best practices to inform recommendations for the UK market;
- consider the role of market practice and market norms in facilitating investment in long-term finance;
- assess what changes in government policy, if any, are needed to support the expansion of long-term capital for growing innovative firms.

BVCA feedback and the Government's response

The consultation paper included an analysis of the UK's market for patient capital, where patient capital is defined as long-term investment in innovative firms led by ambitious entrepreneurs who want to build large-scale businesses. The definition includes debt and equity instruments, and recognises that investment horizons might vary by sector, from three to five years in some sectors, to as long as 10 or 15 in others. The consultation also made clear that the Review would only consider changes to the schemes that are consistent with the existing EU State Aid regime.

The government's response to the consultation was set out in the Autumn Budget. The Chancellor announced an action plan to unlock over £20 billion to finance growth in innovative firms over 10 years. The elements of this that are linked to the BVCA's representations are set out below.

Financing Growth in Innovative Firms

Analysis of the market

Based on a comparison with the US market, HM Treasury estimated that the UK has a "patient capital gap" of around £4 billion per year. This resulted in proportionately fewer innovative UK companies successfully achieving their potential scale when compared to the US. The consultation noted that the UK SME financing market is functioning well in a number of areas and there has been a significant increase in the number of deals involving companies aged less than five years. The paper hypothesised that one of the main reasons for the weaknesses in the market for patient capital is that the capital that flows into the asset class is not being allocated efficiently as a result of a "negative feedback loop" driven by low returns and thin capital markets.

BVCA response – The BVCA report on investment activity and performance measurement survey shows that returns (IRRs) for venture capital funds are improving and that there is also more institutional appetite from UK pension funds. The amounts raised from UK pension funds by BVCA members in 2016 was the highest since the financial crisis at £839 million and 14% of total fundraising. In 2015, this figure was only 6% of the total.

Current Interventions

The consultation paper examined the relative costs of tax reliefs to encourage investment into patient capital and the investment programmes managed by the BBB. The government is making changes to the venture capital schemes to better target them towards high-risk early stage investment, and to reduce their costs. Both in the Review and during BVCA discussions with HMT, the government had highlighted concerns regarding “asset backed” investments and investors not taking the risks the rules were designed to encourage. The paper suggested that government support for early stage investment should come from a mixture of tax reliefs and investment programmes.

BVCA response – We highlighted the value of VCTs, particularly in the context of patient capital, as it is non-cyclical and there is greater certainty over follow up investment. The EIS and SEIS programmes are also of vital importance, as they invest in the very early years of a business’ growth and development. We argued that the government should not attempt to reduce the current levels of the reliefs without a fuller analysis of the benefits they bring to the wider economy. The BVCA agreed to work with the government and suggested amendments to address the concerns they had.

Autumn Budget response

- The annual investment limit for EIS investors will be doubled from £1 million to £2 million, provided that any amount above £1 million is invested in knowledge-intensive companies.
- The annual investment limit for knowledge-intensive firms will be doubled from £5 million to £10 million through the EIS and by VCTs.
- Greater flexibility will be provided for knowledge-intensive companies over how the age limit is applied for when a company must receive its first investment through the schemes.
- The Finance Bill 2017-18 will introduce a principles-based test to ensure that the schemes are focused towards investment in genuine high-growth companies and away from low risk investments.
- The government will review these measures to assess their impact on the market.

National Investment Fund

The headline recommendation in the consultation paper was the establishment of a new National Investment Fund, with investment made through the BBB to crowd in additional institutional investment. As recommended previously by the BVCA, this would address the possibility of the EIF withdrawing from the UK market following Brexit. The consultation presented a number of options for how this could be introduced, including a fund of funds structure, a new investment bank or more funding for the BBB’s existing programmes.

<u>BVCA response</u> – We recommended further funding for the BBB's existing investment programme. The BBB's scale would become both sufficiently diversified to generate strong returns for itself and private investors, while at the same time investing sums in underlying funds that are large enough to help them invest across multiple stages, particularly the later stage funding rounds associated with scaling up a business. To achieve scale in UK venture and growth capital funds, we must attract more private institutional investment and ensure there is a diversity of funding sources for UK businesses. This would encompass the bolstering of the BBB's funding, continued support for the venture capital schemes (VCTs, EIS and SEIS) and support for private sector fund of funds. We recommended that the government should support all of these initiatives rather than focusing resources on a single intervention. In addition, diversification through investment in private equity could help achieve returns private investors are seeking. The EIF has been an active investor in UK venture capital and private equity funds and the BBB should look to replicate this investment programme where possible. This would include reviewing investment criteria to ensure they are flexible, particularly for funds that invest across the UK and Europe.

<u>Autumn Budget response</u> – The government has announced it will:

- Set up a new dedicated subsidiary of the BBB to become a leading UK-based investor in patient capital across the UK, capitalised with £2.5 billion. It will be set up with the intention to float or sell in part or full once it has established a sufficient track record and in line with State Aid rules.
- Invest in a series of private sector fund of funds. The first wave will be seeded by up to £500 million of investment by the BBB. Up to two further waves of investment will be launched, unlocking up to £4 billion in total of new investment.
- Back first-time and emerging venture capital fund managers through the BBB's established Enterprise Capital Fund programme, unlocking at least £1.5 billion in new investment.

The government also notes that the UK's negotiating position remains to explore the potential for a mutually beneficial relationship with the EIF once the UK has left the EU. Allocation of resources across programmes would be reconfigured if the UK does not retain a mutually beneficial relationship with the EIF.

Increasing effective retail investment

The consultation praised the development of listed funds investing in venture capital as they tend to be large enough to provide substantial amounts of follow on funding and focus on the commercialisation of research developed in the UK. The paper suggested that supporting the creation of more listed funds could help meet the aim of the Review.

The government suggested a number of options, such as the FCA facilitating the establishment of new listed investment funds, or the government providing tax reliefs for investment into listed vehicles.

<u>BVCA response</u> – The government needs to encourage institutional investment into listed patient capital vehicles, and we proposed that institutional investors obtain tax relief of up to 30%, on their other UK dividend income. This would mirror the reliefs available to retail investors in VCTs. This would prove particularly attractive to pension funds and charitable foundations who would be appropriately incentivised to increase their weightings in a higher risk asset class.

<u>Autumn Budget response</u>

- As part of its broader remit, the FCA's new Asset Manager Authorisation Hub will support firms to better understand regulatory requirements around holding illiquid investments, and will hold a dedicated event on long-term investment next year.

Shifting attitudes to investment in patient capital

The consultation noted that the fragmentation of UK pension funds could be a cause of underinvestment in patient capital, and points to existing Department for Work and Pensions (DWP) reviews intended to facilitate the pooling of pension schemes. The consultation paper argued that the reluctance of DC schemes to invest in illiquid assets was driven by market practice where investment platforms used by DC schemes require investments to be priced and traded on a daily basis. It therefore concluded that any attempt to reduce this barrier to DC investment should be industry-led.

BVCA response – As more money has flowed into DC schemes, fund managers have adopted default investment options for their members. Defaults have many of the characteristics of a DB fund as they are managed by professionals and invest across a range of asset classes over the long-term, with specific targets in mind. The BVCA is working with other market participants on this area to develop the necessary infrastructure for DC pension savers. We also argued for the removal of the regulatory "charge cap" of 0.75% that can be borne by investors in default funds that are set up by employers to meet their automatic enrolment duties.

Autumn Budget response

- HMT will establish a working group of institutional investors and fund managers to increase the supply of patient capital, including tackling continuing barriers holding back DC pension savers from investing in illiquid assets
- The Pensions Regulator will clarify guidance on how trustees can include investment in assets with long-term investment horizons, such as venture capital, infrastructure, market-returning investments that have a social benefit and other illiquid assets in a diverse portfolio.

Other measures

In addition to the above, the government has also confirmed it will:

- Back overseas investment in UK venture capital through the Department for International Trade. This is expected to drive £1 billion of investment.
- Carry out a study assessing how to support the next generation of high potential fund managers to develop their knowledge and skills and to raise their first or next fund.
- Identify ways to tackle barriers faced by female-led firms in accessing venture capital through new behavioural research commissioned by the BBB.
- Call on venture capital and other financial services firms to join over 160 other financial services firms in signing HMT's Women in Finance charter and committing to improve gender balance. The Charter pledges include: setting a target for gender diversity in senior management (which could mirror or exceed those suggested by other initiatives); committing to publish that target and progress made against it on an annual basis; and creating a link between pay and achievement of the target. The government welcomes existing initiatives like Level 20 and Diversity VC in raising awareness of this issue.

In the long term, we hope that the outcomes of this Review promote growth and innovation in a post-Brexit world. A more positive dialogue that is based on mutual trust and a common set of objectives should be a cause for optimism in uncertain times.

03.

The Walker Guidelines: Ten years on

Sundip Jadeja, BVCA

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Sundip Jadeja
BVCA

This year marks the tenth anniversary of the publication of the Guidelines, authored by Sir David Walker, to increase transparency across the UK private equity industry. Amidst public scrutiny and negative publicity faced by the industry in 2007, culminating in senior industry executives being questioned by the Treasury Committee, the BVCA asked Sir David Walker to undertake an independent review of the adequacy of disclosure and transparency in private equity. A set of voluntary Guidelines was proposed targeting the largest private equity-backed companies in the UK. An independent body, now known as the Private Equity Reporting Group (PERG), was established to monitor compliance with the Guidelines. Next month the PERG will publish its tenth annual report.

What do the Guidelines entail?

The Guidelines cover the largest private-equity backed companies with a significant presence in the UK, as well as their private equity owners.

Portfolio company requirements

- 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 the FTSE 350.
- Portfolio company annual reports, as well as a mid-year update, should be published on the company's website in a timely manner.
- Portfolio companies are also required to share data, which is presented on an aggregate basis in a performance report to illustrate the contribution of the industry to the broader economy in terms of employment, productivity and growth, benchmarked against the performance of quoted companies.

Private equity owner requirement

- Portfolio companies are also required to share data, which is presented on an aggregate basis in a performance report to illustrate the contribution of the industry to the broader economy in terms of employment, productivity and growth, benchmarked against the performance of quoted companies.

Have the Guidelines increased disclosure and transparency within the private equity industry?

The effectiveness of the Walker Guidelines lies in the fact that an independent group, consisting of three independent members and two industry representatives, regularly monitors compliance by portfolio companies and their private equity-owners. Unlike other self-regulatory regimes, the private equity firms involved with this process are held to account as the PERG publishes an annual report that comments on compliance with all aspects of the requirements. The PERG does not shy away from naming companies that have not complied with the Guidelines. Such public "naming and shaming" encourages adherence with the Guidelines in the future.

There is no denying that the level of disclosure and transparency has improved in the industry since 2007. No longer are private equity firms seen as completely "private" in their behaviour. Indeed, it would now be highly unusual if a private equity firm did not have a website that disclosed its strategy, the portfolio companies it has invested in, and its senior team. Similarly, the detail and quality of disclosures by large private equity-backed portfolio companies has continued to improve. This is due to the efforts of the private equity firms and the improvement in quoted company reporting in the past decade as this is the benchmark for judging compliance and has driven better reporting by portfolio companies.

How have the Guidelines changed?

As part of the PERG's mandate to ensure the level of disclosure and transparency expected remains appropriate, the PERG also regularly reviews the scope of the Guidelines. The PERG strives to ensure the Guidelines remain relevant as the private equity industry has continued to evolve and as expectations on transparency by stakeholders have increased. As a result, the Guidelines and those required to comply with them have evolved in a number of ways over the past ten years.

The number of portfolio companies in scope of the Guidelines has increased substantially since 2007. The definition of portfolio companies was changed by the PERG so that private equity-backed companies with a significant UK interest are captured by these Guidelines. There were 27 portfolio companies in scope of the Guidelines in the first PERG report, peaking at 73 in 2013. In the last few years this has fallen to under 60 companies, reflecting the increasing number of exits following the downturn.

Similarly, the number of private equity owners within scope of the Guidelines has increased over the last decade. This has been driven by the increasing number of "private equity-like" owners in scope with such owners equalling the number of traditional owners in recent years. Private equity-like firms are firms that conduct their business in a manner that would be perceived by external stakeholders to be similar to that of other participants in the private equity industry. An influx of private equity-like firms in scope of the Guidelines can be explained by many former investors, such as pension and sovereign funds, now investing directly, as well as an increasing number of infrastructure and credit funds that behave in a private equity-like manner. Many of these firms are non-BVCA members, which has led to difficulty in engagement, and thus a decrease in compliance with the Guidelines in the last few years.

Other developments include:

- The revision of the Guidelines in 2014 to implement strategic report requirements, typically applicable to quoted companies. This includes disclosures on human rights and gender diversity.
- In 2018, the PERG will review the implications of the transposition of the EU non-financial reporting directive into Companies Act 2006.

Are the Guidelines still relevant today?

Ten years on, the Walker Guidelines are more relevant than ever. With increasing scrutiny on the behaviour of large private businesses, the industry would be wise not to forget the events of 2007. It remains in the hands of private equity investors to illustrate that these voluntary Guidelines remain effective and to demonstrate the industry is transparent. No doubt, a self-regulatory regime with a robust mechanism to review compliance is preferred over any mandatory legislation and regulation. Until now, regulators and the government have recognised the good work of the Guidelines (which is discussed in Victoria Sigeti's article on corporate governance reforms. The Guidelines and the work of the PERG remains critical in demonstrating how the private equity industry are responsible owners and stewards of the UK's largest companies, as well as to showcase the asset class's positive contribution to the UK economy.

04.

The impact of the SM&CR on private equity

Paul Ellison, Macfarlanes

04. The impact of the SM&CR on private equity

Paul Ellison
Macfarlanes

The FCA is planning to extend the Senior Managers and Certification Regime (SM&CR) to almost all financial services firms, including private equity firms, in 2018. This note provides an overview of the main features of the SM&CR and assesses the key impacts of the SM&CR for private equity firms.

Why is the FCA making this change?

The regulators introduced the SM&CR in March 2016 to increase individual accountability in banks, building societies, credit unions, PRA-designated investment firms and branches of foreign banks operating in the UK. The SM&CR replaced the Approved Persons Regime for these firms, under which the FCA regulates individuals working in financial services. The FCA emphasises that it wants “all firms to develop a “culture of accountability” at all levels and for senior individuals to be fully accountable for defined business activities and material risks”. The FCA recognises that it is not appropriate to adopt the same approach as it did when implementing the existing SM&CR and has highlighted the importance of developing a flexible and proportionate approach to account for different governance structures and business models.

What is the FCA proposing?

The FCA proposes the following three-tier model:

- **Core Regime**: the FCA proposes a standard set of requirements for all firms not currently subject to the SM&CR and that will not be subject to the Enhanced Regime or the Limited Scope Regime described below. It refers to firms in this regime as “Core Firms”. The Core Regime comprises the following elements: the Senior Managers Regime; the Certification Regime; and the Conduct Rules. We expect most private equity firms to be Core Firms.
- **Enhanced Regime**: for a small number of firms whose size, complexity and potential impact on consumers justify further attention (“Enhanced Firms”), the FCA will impose additional requirements. Such firms include those with assets under management of £50bn or more (at any time over the past three years) and firms categorised as “significant IFPRU investment firms” for prudential purposes.
- **Limited Scope Regime**: firms subject to a limited application of the current Approved Persons Regime will only have to comply with a reduced set of requirements (“Limited Scope Firms”). The vast majority of private equity firms are unlikely to fall within this regime. Limited Scope Firms will include firms for which financial services is an ancillary part of their business, for example, a car dealership with a consumer credit licence.

What are the key features of the proposed Core Regime?

Senior Managers Regime

Individuals performing senior management functions (SMFs) will require FCA approval before starting their role. These individuals (“Senior Managers”) must also have a statement of responsibilities setting out clearly what they are responsible for. Core Firms must allocate certain “prescribed responsibilities” to the appropriate Senior Manager. Each Senior Manager will be under a “duty of responsibility” and could be held accountable for a regulatory breach within their area of responsibility if they did not take reasonable steps to prevent that breach.

The FCA proposes the following SMFs for the Core Regime, all of which are controlled functions under the current approved persons regime:

GOVERNING FUNCTIONS	REQUIRED FUNCTIONS
SMF1: Chief Executive	SMF16: Compliance Oversight
SMF3: Executive Director	SMF17: Money Laundering Reporting Officer
SMF9: Chair (Non-executive)	
SMF27: Partner	

Certification Regime

The Certification Regime applies to individuals who are not Senior Managers but who may cause significant harm to the firm or to customers due to the nature of their role. Such individuals do not need prior FCA approval but firms must certify that they are fit and proper to perform their role (their "Certification Function") at least annually. The FCA proposes the following Certification Functions:

- Significant management function (including people with "significant responsibility for a significant business unit");
- Proprietary traders;
- CASS oversight function;
- Functions that are subject to qualification requirements;
- Client dealing function;
- Algorithmic traders;
- Material risk takers (remuneration code staff); and
- Anyone who supervises or manages anyone performing any of the functions above (directly or indirectly).

If there is no-one in these roles, then the Certification Regime will not be relevant. If one person performs two roles, this is permissible, but the firm must certify that person for both roles.

Conduct Rules

The Conduct Rules are high-level standards of behaviour for all employees. However, certain rules only apply to Senior Managers. The Conduct Rules set a basic standard of conduct which is similar to that under the Statements of Principle for Approved Persons, however, the Conduct Rules apply to a much wider employee base. The Conduct Rules apply to a firm's regulated business but also to "unregulated financial services activities", for example, an activity carried on in connection with a regulated activity. Firms must:

- notify all relevant staff of the Conduct Rules that will apply to them;
- take reasonable steps to ensure the staff understand how the Conduct Rules apply to them including training and assessment of staff; and
- notify the FCA when formal disciplinary action is taken against a person for breaching the Conduct Rules. For Senior Managers, this notification must be made to the FCA within seven business days of the firm becoming aware of the matter. For other employees, the FCA proposes an annual notification process.

The obligation to train and formally supervise these employees will be onerous and will require firms to implement an objective assessment process. The FCA expects firms to be able to demonstrate that they comply with the spirit as well as the letter of the Conduct Rules, for example, in ensuring staff understand what the rules mean to them in the context of their firm. In practice, it likely that the FCA will expect firms to adopt annual assessments of individuals' fitness and propriety, include compliance issues as a meaningful part of its appraisal process and implement training for staff.

How do the Enhanced and Limited Scope Regimes differ?

Additional SMFs will apply to an Enhanced Firm's business and such firms will have to allocate more "prescribed responsibilities". Enhanced Firms will also have to comply with the requirement to have adequate handover procedures, where a person taking over a new role as a Senior Manager must have all the information and material that they could reasonably expect to perform their role. There are also requirements to have a "responsibility map" (a single document setting out management and governance arrangements) and to ensure that there is a Senior Manager with overall responsibility for each area of the firm.

Apart from the obligation to allocate prescribed responsibilities, Limited Scope Firms will have to comply with the same requirements as Core Firms. Fewer SMFs will apply to Limited Scope Firms.

What are the key issues for private equity firms?

Passive LLP members and junior members

Core Firms and Enhanced Firms which are structured as a limited liability partnership (LLP) will be subject to SMF27. This captures "a partner in a firm [including an LLP], other than a limited partner in a partnership registered under the Limited Partnership Act 1907." For many private equity firms, the breadth of SMF27 may raise questions as to the scope of the SMFs for their business, particularly where a large number of team members below the most senior tier of management have been admitted as members of the LLP or where an LLP has passive investor members.

The FCA has clarified that a person acting as a partner must also meet the FSMA definition of a "senior management function" in order to be treated as performing SMF27. In practice, this means that only those partners that are involved in the management of the firm will be captured. This clarity is important to ensure that SMF27 is applied in a manner that accurately reflects the governance of private equity firms.

Material risk takers

The material risk taker Certification Function appears to include employees who are not actually taking material risks on behalf of the firm, as it is based on a firm's remuneration code staff (which includes employees receiving the same level of remuneration as "risk takers"). For private equity firms, front-office executives who are not otherwise performing a Certification Function could be deemed to undertake such a role solely due to the quantum of their remuneration. Further clarity from the FCA would be helpful for the private equity industry.

Executives located abroad

The FCA applies a territorial limitation to the Certification Regime, by only capturing those employees performing a Certification Function in the UK or, if based outside the UK, dealing with UK clients. "Dealing with" in this context has a broader meaning than simply "dealing in investments" and includes having contact with clients.

However, if an individual is a material risk taker under one of the FCA remuneration codes, the Certification Regime will apply even if they are based overseas and do not deal with UK clients. This could pose challenges for private equity firms with a large international presence.

Client dealing function

The new client dealing function applies more broadly than the current CF30 controlled function. It covers those who deal with all types of clients and not only retail clients. While some private equity firms already have CF30 approval for employees dealing with professional clients, there has been some disparity in the industry. All private equity firms will therefore need to consider carefully which employees will be performing the wider client dealing function.

Demonstrating fitness and propriety

The burden of ensuring that an individual is fit and proper to perform their role will fall on each firm rather than the FCA. While the assessment criteria are not fundamentally different to the current regime, private equity firms must have systems in place to support this new responsibility. For example, it will be crucial to keep detailed records of the fitness and propriety assessment process. It remains to be seen whether the FCA will clarify that firms can apply the assessment proportionately, which may ease the administrative burden for smaller private equity firms.

Conduct Rule notifications

Firms will have seven business days to notify the FCA of disciplinary action regarding Senior Manager Conduct Rule breaches. This is shorter than other well-established timeframes currently used in the private equity market and may cause operational difficulties. Firms may also face issues in identifying when the firm is deemed to become aware of the matter. For example, in some scenarios it may be when the compliance officer becomes aware or when a senior partner becomes aware.

Regulatory references

When hiring new employees, all firms will have to take reasonable steps to obtain appropriate references from the current employer, and all previous employers in the past six years, for individuals seeking to be Senior Managers, Certified Function holders and NEDs. Where private equity firms are asked to provide such references for departing employees, this may cause internal tensions between HR, Legal and Compliance as the references will also need to be in line with employment law and current practice. For example, the new level of information required in a regulatory reference may make it harder to reach exit settlements with employees who have been subject to disciplinary proceedings.

Next steps

The FCA aims to publish the final rules in a policy statement in 2018 and HM Treasury will specify when the new regime comes into force. It is unclear when this may be, although it is likely to be towards the end of 2018. The FCA intends to publish an additional consultation paper on the operational aspects of the new regime, which will include transitional arrangements. This may compensate for a potentially short implementation period and it is expected that the phased implementation will mirror that of the current SM&CR.

Private equity firms should consider establishing an internal working group (where proportionate to their size and complexity) to consider how to implement the SM&CR including representation from HR, Compliance and Legal (where a firm has each of those functions). Firms may also wish to consider undertaking a gap analysis and impact assessment of the implications of the SM&CR on their business.

05.

EBA's Proposals for a New Capital Regime for Investment Firms

James Smethurst, Freshfields Bruckhaus Deringer

05. EBA's Proposals for a New Capital Regime for Investment Firms

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Introduction

On 29 September 2017 the European Banking Authority (EBA) published its recommendations for a new capital regime to apply to European investment firms ("Opinion on the design of a new prudential framework for investment firms"). The proposals are the culmination of several years' work by the EBA which began with the European Commission's call for advice from the EBA in December 2014. Responsibility now shifts back to the Commission to publish legislative proposals for a new capital regime.

Currently, some investment firms are subject to the same regime as credit institutions comprised in the Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR), but modified in certain respects. Others, however, are subject to aspects of the pre-CRD/CRR regime. In short, investment firms are subject to a patchwork of capital regimes, none of which were specifically designed for their particular circumstances. The proposals seek to create a single framework for all investment firms, which is intended to be more suited to the risks presented by such firms. However, in attempting to create a single regime for investment firms, the EBA's proposals risk creating a regime which does not appropriately reflect the risks of all investment firms, particularly private equity firms that are "adviser/arrangers", and is likely materially to increase the capital requirements of many private equity firms.

Design of the Regime

Classes of investment firms

The proposals divide investment firms into three tiers:

- Class 1: systemic investment firms or investment firms which are exposed to the same risks as credit institutions;
- Class 2: other non-systemic investment firms; and
- Class 3: small non-interconnected investment firms providing limited services in terms of number and size.

Private equity firms will fall within either Class 2 or Class 3 depending on the nature and scale of their activities. The EBA proposes a series of conditions ("categorisation thresholds") which, if met, would exclude a firm from being treated as a Class 3 firm. So, for example, if a firm holds any client money or client assets, or has gross revenues of more than €30mn it will be Class 2 and not Class 3. Similarly, if a firm has assets under management (K-AUM) under both discretionary and non-discretionary (advisory) arrangements of more than €1.2bn it will be a Class 2 firm. It is not yet clear how the calculation of K-AUM will apply to private equity firms which are sub-advisers.

Initial and minimum capital

As under the current regime, investment firms will be subject to initial and minimum capital requirements ("permanent minimum capital" or PMC):

- €750,000 for investment firms that are authorised to carry on the following investment services: dealing on own account, underwriting on a firm commitment basis or operating an MTF or OTF;

- €75,000 for investment firms that are not permitted to hold client money or securities and are authorised to provide the following investment services: reception and transmission of orders, execution of orders on behalf of clients, portfolio management, investment advice and placing on a non-firm commitment basis;
- €150,000 for all other investment firms.

These amounts will represent the absolute floor for capital for Class 2 and 3 firms. However, because the actual minimum capital requirement will be the higher of the amount calculated using the K-factors (for Class 2 firms), a fixed overhead requirement (FOR) and the PMC, for many firms their minimum capital requirement will be considerably in excess of the absolute floor.

The K-factors

Class 2 investment firms will be subject to a capital calculation based on the application of K-factors. The K-factors represent three broad categories of risk:

- risk to customer (RtC)
- risk to firm (RtF)
- risk to market (RtM)

The capital requirement for Class 2 firms is the sum of the K-factors for each of these categories of risk: RtC + RtF + RtM. Not all of these categories of risk, and the K-factors, will be relevant to all firms. In particular, the K-factors in RtF and RtM are unlikely to apply to private equity firms which advise on and arrange transactions or carry out portfolio management as these capture risks where the firm is dealing on its own account.

The K-factors within RtC could, however, be relevant to some private equity firms. These K-factors cover:

- K-AUM: assets under management – under both discretionary and non-discretionary (advisory) arrangements;
- K-CMH: amount of client money held;
- K-ASA: amount of client assets safeguarded and administered; and
- K-COH: volume of customer orders handled (value of transactions of execution-only in the name of the client and of orders received and transmitted).

How the K-AUM factor is calculated for firms which act as advisers or sub-advisers will be a key issue for some private equity firms, and could be a significant determinant of how much capital they are required to hold.

Where a K-factor is relevant to a Class 2 firm (e.g. where a firm has assets under management or holds client money) then the capital requirement is calculated by applying a "co-efficient" (essentially a percentage figure) to the relevant metric. So, for example, for a firm which has assets under management, the capital requirement for this K-factor will be calculated by applying 0.02% to the value of assets under management. The total capital requirement is the sum of the amount of capital required by applying the relevant co-efficient to each K-factor which is relevant to the firm. The EBA proposes the development of a smoothing regime to mitigate the impact on capital of fluctuating K-factor values (if the value of assets under management or held in custody fluctuates materially with changing market values this could impact the amount of capital firms would have to hold).

Fixed Overhead Requirement (FOR)

For many private equity firms the K-factors may not be relevant at all (depending upon the approach to K-AUM). However, all firms in Class 2 or Class 3 will be subject to the minimum FOR. This will be calculated as at least 25% of the firm's fixed overheads from the previous year calculated using the methodology under CRD/CRR (Delegated Regulation 488/2015). For firms that are currently exempt CAD firms (those firms which are advisers/arrangers), which are subject to a flat €50,000 requirement, the application of the FOR could result in a very significant increase in capital where the firm has relatively significant fixed costs such as professionals' salaries.

Composition of capital

The capital instruments which investment firms can include as capital to meet the requirements will follow the definition of regulatory capital in CRD/CRR for credit institutions, including Core Equity Tier 1 (CET 1), Additional Tier 1 and Tier 2. The EBA proposes that investment firms be subject to the following limits:

- CET 1 should constitute at least 56% of the capital requirements;
- Additional Tier 1 can be included up to 44% of capital requirements; and
- Tier 2 can constitute up to 25% of capital requirements.

Similar deductions from regulatory capital will apply as for credit institutions, in particular intangible assets, deferred tax assets and significant holdings in other financial institutions (unless included within the scope of group supervision) will need to be deducted.

Liquidity

The EBA's proposals also include a new liquidity regime for Class 2 and 3 investment firms. Such firms will need to adopt internal rules and procedures to enable them to monitor, measure and manage exposures and liquidity needs and to ensure the adequacy of liquidity resources. The EBA also proposes a requirement for Class 2 and 3 firms to hold liquid assets equal to one third of their FOR. The proposals indicate that the liquid assets which will be eligible to meet the liquidity requirement will be unencumbered cash of the investment firm or those assets in Level 1, 2A and 2B High Quality Liquid Assets (HQLA) set out in the Commission's Delegated Regulation on the liquidity coverage requirement (Regulation 2015/61) for credit institutions. Given the nature of many of these assets (and the haircuts which are applied to the lower quality assets), it is quite likely that many firms will end up having to lock up cash to meet the liquidity requirement.

Consolidated Supervision

The EBA recommends the establishment of a framework for the supervision on a consolidated basis of groups that consist only of Class 2 and 3 investment firms (i.e. there are no credit institutions or Class 1 investment firms in the group). Under this regime the ultimate EU parent company would be responsible for the prudential requirements of the group, and should put in place systems to monitor and control sources of capital and funding for all regulated entities in the group. In addition, the parent company of an investment firm only group would be subject to a group capital test (based on the test currently applied under CRR when groups are seeking a waiver from consolidated supervision) to address excessive leverage and multiple gearing of capital.

However, regulators would also be given power to apply a capital requirement calculated on a consolidated basis to such investment firm only groups if certain conditions are met: for example, the group has been deliberately structured so as to fall below the thresholds for the K-factors to apply to individual investment firms in the group, or if the investment firms in the group are sufficiently interconnected to justify imposing a consolidated capital requirement.

Governance and remuneration

Class 2 and 3 firms will be subject to lighter governance requirements than Class 1 firms, which will be subject to the full CRD/CRR governance requirements. In general, the CRD/CRR regime will not apply to Class 2 and Class 3 firms, which will instead be subject to the MiFID II minimum requirements. However, aspects of the CRD/CRR regime will be applied to certain Class 2 firms depending on their activities (for example, whether the firm holds client money or deals on own account).

In relation to remuneration requirements, the EBA proposes that Class 1 firms will continue to be subject to the full CRD/CRR remuneration rules, while Class 3 firms will be subject to the MiFID II minimum requirements. The EBA proposes that Class 2 firms be subject to the CRD/CRR requirements for employees that can have a material impact on the firm's risk profile, while the MiFID II requirements would apply to other staff. The EBA's recommendation invites the Commission to consider the advantages and disadvantages of applying the bonus cap to Class 2 firms. Since it is likely that the vast majority of investment firms will be Class 2 firms, if the Commission decides to apply the cap this could result in the application of the bonus cap and other remuneration rules to firms that are currently not subject to it or can disapply it under the proportionality approach.

Transitionals

The EBA has recognised that if its proposals are implemented this could result in increases in the amount of capital individual firms are required to hold. It is therefore recommending that firms' capital requirements are limited to a maximum of twice the level required under the current regime for a period of three years after the new regime comes into effect. For some firms the requirements under the new regime will be many times greater than twice the current level, so while the three year cap is welcome it will still see firms having to hold significantly greater amounts of capital at the end of that period.

Conclusion

While there is much to be said for a capital regime that is specifically designed for investment firms, there are also many issues with the EBA's proposals. In particular, it is arguable that the regime overstates the risks (and therefore the amount of capital required to be held) by certain types of investment firms which provide investment advice, receive and transmit orders or conduct portfolio management. This includes private equity firms, who could see their capital requirements increase materially even if they are subject only to the FOR.

The ball is now in the Commission's court to produce a legislative proposal, which must then go through the EU legislative process. It is extremely unlikely that this will be completed before the expected date of the UK's departure from the EU in March 2019. The UK Government and regulators will therefore need to determine whether to follow the EU's new regime, retain the status quo or develop a UK-specific regime.

06.

Corporate Governance Reform

Victoria Sigeti, Freshfields Bruckhaus Deringer

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In the May 2017 Technical Bulletin, we discussed the Department for Business, Energy and Industrial Strategy (BEIS) Green Paper on corporate governance reform (published in November 2016), the House of Commons BEIS Committee's recommendations (published in April 2017) and the BVCA's engagement in the consultation process in relation to UK corporate governance reform.

Post-general election, corporate governance reform has continued to be on the government's agenda and consequently it remains a focus for the BVCA. In August 2017, BEIS published its response to the Green Paper and the Financial Reporting Council (FRC) published a set of draft amendments to its Guidance on the Strategic Report (the Guidance).

This article provides an update on these topics as they relate to privately held companies.

BEIS Response to the Green Paper

The BEIS response to the Green Paper, which largely reflects the committee's April 2017 recommendations, sets out a package of measures, some of which will be applicable to large privately held businesses as well as public companies.

These measures are designed to:

- Drive change in how large private companies engage with employees, customers, suppliers and wider stakeholders to build more sustainable performance and to build confidence in the way they are run; and
- Encourage large private companies to adopt stronger corporate governance arrangements, reflecting their economic and social significance, through the development of a set of corporate governance principles and the introduction of mandatory corporate governance reporting.

The proposed measures are expected to come into effect by June 2018 to apply to company reporting years commencing on or after that date. However this timetable could change.

Corporate governance principles

The BEIS response proposed that a group be convened, comprising the BVCA, the FRC, the Institute of Directors, the CBI and the Institute for Family Businesses to develop a voluntary set of corporate governance principles for large private companies. The BVCA welcomes the opportunity to be part of this group and to help shape the principles. It is too early to speculate on what these principles might ultimately look like but the BVCA will focus on ensuring that they are not unduly burdensome for private companies and that they recognise the diversity of companies which may be covered.

Whilst the application of the principles will be voluntary (in part, to enable companies to continue to use other industry-developed codes and guidance), large private companies will be required to report on their corporate governance arrangements in their directors' reports and on their websites, including as to whether they adhere to the principles, or any other corporate governance code.

With certain exceptions, BEIS's initial view is that this reporting requirement should apply to companies with more than 2,000 employees, although this remains subject to further consideration. The BVCA's view is that, to achieve meaningful coverage, the test should be broader than solely employee numbers and should include some form of financial criteria and/or UK nexus.

The BEIS response makes reference to the Walker Guidelines as an industry-developed code that certain companies already report under. This acknowledgement is helpful, although we expect that there will be limited overlap between the Walker Guidelines and this aspect of corporate governance reporting since the Walker Guidelines focus on reporting on a company's business activities rather than its corporate governance arrangements.

Section 172 reporting

The BEIS response confirms that the government intends to introduce secondary legislation to require large private companies, as well as public companies, to explain how their directors comply with the requirements of section 172 Companies Act 2006 to have regard to employee interests and to fostering relationships with suppliers, customers and others. It envisages that this reporting will include a requirement to explain how the company has identified and sought the views of key stakeholders, why the mechanisms adopted were appropriate and how this information has influenced boardroom decision making.

There is likely to be some degree of overlap between the proposed new section 172 reporting and reporting under the Walker Guidelines, although the Walker Guidelines do not require the level of specificity which appears to be proposed.

BEIS has proposed that companies with more than 1,000 employees should be subject to this new reporting requirement, but this remains subject to further consideration.

FRC Guidance on the Strategic Report

The FRC published a consultation draft of its proposed updates to its Guidance in August 2017. The purpose of the updates is expressed to be threefold:

- To reflect changes arising from the UK implementation of the non-financial reporting Directive;
- To enhance the linkage between section 172 of the Companies Act 2006 and the purpose of the strategic report; and
- To make targeted improvements to certain areas.

The BVCA submitted a response to the draft amendments in October 2017 which emphasised the following points:

- The BVCA is supportive of improved disclosure to shareholders (as indicated by the introduction of the Walker Guidelines ten years ago) and believes that the Guidance plays an important role in this. For the most part, the BVCA is supportive of the proposed amendments.
- Whilst the BVCA agrees with the FRC that the strategic report has the potential to be useful to wider stakeholders, the BVCA is concerned about the emphasis given to stakeholders in the updated Guidance and the potential for this to confuse market participants as to who the strategic report is for. The BVCA's view is that until legislation in respect of stakeholder engagement is final, it would be preferable for the Guidance not to go beyond what is required by the existing law.
- Certain aspects of the Guidance (in particular, those relating to reporting on sources of value and how value is generated), have the potential to place an increased administrative burden on companies that may not have a large number of people within their reporting functions. The BVCA would welcome a specific acknowledgement in the relevant sections of the Guidance that focussed and relevant reporting is the key objective.

Next steps

The BVCA will continue to engage with relevant stakeholders in respect of the corporate governance principles, the new section 172 reporting requirements and the Guidance, to seek to ensure that these are developed in a manner which adds value and does not impose a disproportionate burden on privately held businesses.

07.

General Data Protection Regulation

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07. General Data Protection Regulation

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Overview

The General Data Protection Regulation (2016/679) (GDPR) will take direct effect on 25 May 2018 repealing the Data Protection Directive (95/46/EC), which was implemented in the UK by the Data Protection Act 1998.

All businesses in the European Union must be fully compliant with the GDPR by 25 May 2018. Time to prepare is short and, although data protection authorities may act leniently in the early days of the new regime, there is no formal transitional relief to protect existing processing and practices. Therefore both fund managers and private equity portfolio companies should ensure that their preparations are underway now.

Key changes

The basic principles of data protection law remain largely unchanged: fairness, legitimacy, proportionality, security and restrictions on international data transfer. Fund managers and portfolio companies should remember that personal data should not be processed other than where the conditions of transparency, legitimate purpose and proportionality are met.

However, the GDPR introduces new concepts and approaches which will result in most businesses needing to perform a root and branch review of data processing. There is a strong emphasis in the new regime on "accountability" – not just acting fairly and reasonably in the processing of personal data, but having in place a data privacy superstructure designed to ensure, monitor and record compliance.

In particular, the GDPR introduces significant changes in relation to consent, data protection impact assessments and the appointment of data protection officers. Significant new fines are also imposed in the event of a breach. To the extent not already underway, we recommend that fund managers and portfolio companies conduct a review of their data processing procedures and, in the case of portfolio companies, investor directors or fund managers should check this is taking place.

Expanded territorial scope

The GDPR will significantly extend the application of the EU data protection regime, catching GPs and fund managers outside the EEA.

The GDPR, like the current directive, will apply to data controllers (the person who determines the purposes and manner in which personal data is processed) established in the EU, but it will also apply to data processors (a person who processes personal data on behalf of the data controller) and to organisations outside the EU which offer goods or services to EU data subjects or monitor their behaviour.

The GDPR also asserts extraterritorial effect. Broadly, the current data privacy regime applies to processing where the controller and processing activity has a European nexus (e.g. where the controller is established in the EEA or uses equipment in the EEA to carry out the processing activities).

The new rules will also apply to processing entirely outside of the EEA (i.e. if such processing is carried out in order to offer goods and services to, or monitor the behaviour of, individuals within the EEA).

"One-Stop-Shop"

The GDPR introduces a consistency mechanism regarding supervision and enforcement of its requirements. This is the so-called "one-stop-shop".

Broadly, the one-stop-shop provides for legal entities within the GDPR's scope established in more than one member state to be regulated by a single lead regulator. The lead authority will be required to coordinate with other local regulators as relevant to the supervision of the relevant regulated legal entity.

The lead regulator will be the regulator in the member state in which the legal entity has its "main establishment". The test for "establishment" is broad. In practice, establishment will usually be ascertained by reference to the relevant entities main administrative location in the EU, unless significant decisions about data processing take place in a different member state.

Rights for data subjects

Obligations owed to data subjects are enhanced by the GDPR. These rights include explaining the basis on which the processing (and any international transfer outside the EEA) is justified, the length of time for which the data will be retained and rights to lodge complaints with the data protection authority.

Consent

Subtle but important changes are made to the requirements for effective consent. Data controllers will be required to demonstrate that a data subject's consent has been obtained, and that the consent is "unambiguous".

The existing practices for obtaining consent therefore need to be reviewed to ensure businesses can demonstrate such consent has been obtained. The consent of a data subject may also always be withdrawn (which is not the current position under UK law) and parental approval will be required for processing children's data.

Data portability

A new limited right for data subjects to request (i) the return of their data to them, or (ii) that their data is passed on to a new replacement data controller has been introduced. The data will need to be transferred in a commonly used, "machine-readable" format. This is the so-called "data portability" right. The data portability right is principally aimed at social media and similar online contexts and businesses in these areas will already be working to address data portability issues in their GDPR implementation strategies.

Recent EU guidance notes that the GDPR does not establish a general right to data portability where the processing of personal data is not based on consent or contract. Fund managers and portfolio companies should therefore consider the circumstances in which the portability right may be used against their respective businesses. If portability would not be feasible or appropriate, consideration should be given to how the right can be avoided (e.g. by relying on "legitimate interests" rather than "consent" to justify processing).

Right to be forgotten

The GDPR does not add much to the existing "right to be forgotten", where an individual can require a data controller to erase their personal data in limited circumstances. It codifies existing EU law. The right will not arise as long as the controller has a legitimate reason to continue processing the data, and once that legitimate reason has expired the controller should in principle delete or anonymise the data anyway, irrespective of the exercise of the right.

Data protection impact assessments

Businesses will be required to carry out data protection impact assessments before carrying out any data processing which involves new technology which is likely to be of high risk to data subjects. Where such assessment deems that the data processing would result in a high risk to individuals, the business must consult with the national data protection authority before any data processing takes place. Non-compliance with the data protection impact assessment requirements can lead to fines imposed by the competent regulator.

The GDPR takes a risk-based approach to compliance. So a data protection impact assessment will not be required in every case. In practice, at least basic assessments will be needed of all processing arrangements (i.e. to ensure they are GDPR-compliant and determine whether full data protection impact assessments are required).

Record keeping and data protection officers

The GDPR requires businesses to maintain detailed documentation recording their data processing activities. These obligations do not apply to organisations employing fewer than 250 people, other than in certain limited scenarios (e.g. where the processing activities are likely to result in a high risk to individuals or the processing includes sensitive personal data). Therefore this will be relevant to many portfolio companies, but most fund managers will not be caught by the employee threshold. However fund managers and portfolio companies need to remain compliant with the existing data protection legislation, for example when fund managers receive personal data as a result of AML checks they should ensure there is a legitimate interest in obtaining such information and that the information is proportionate.

Companies processing sensitive data on a large scale or whose core activities require regular and systematic monitoring of data subjects on large scale will need to appoint a data protection officer. Such data protection officers must have applicable expert knowledge and be able to perform their duties and tasks in an independent manner, which may prove challenging for smaller businesses.

Breach

There is no general "security breach notification" concept under the existing EU data privacy rules. Two new obligations are introduced by the GDPR in the event of a breach.

Firstly, controllers must report all security breaches to the relevant regulator without undue delay, and where feasible, within 72 hours of the controller becoming aware. Secondly, if the breach would likely result in a "high risk" to the "rights and freedoms" of the data subject, the controller must inform the affected data subjects. Processors must also inform their controllers when they become aware of security breaches without undue delay.

A rapid response to each data security breach will be required. Portfolio companies will therefore need to develop a plan enabling them to respond quickly to a data breach. If any technology is outsourced, portfolio companies should consider (i) whether (and, if so, when) they would receive notification of any breach; and (ii) building security breach notification obligations into their contractual framework and security breach readiness strategy.

Enhanced sanctions and remedies for breach

The GDPR substantially increases the risks associated with failure to comply with the EU data privacy regime by increasing the potential sanctions for breach. Potential sanctions fall into four categories: (i) administrative fines; (ii) civil sanctions; (iii) regulatory action; and (iv) criminal penalties.

Currently fines under national law vary and are fairly low, for example in the UK the maximum fine is £500,000. The GDPR increases the fines the competent data protection authority will be able to impose fines of up to: (i) 4% of global turnover or €20mn (whichever is greater for infringements such as breach of international data transfer provisions), or (ii) 2% of global turnover or €10mn (whichever is greater for more minor infringements).

Previously under the Data Protection Directive, statutory obligations were only imposed on data controllers, not data processors. Under the GDPR statutory obligations are imposed on both data controllers and data processors and both will be subject to fines.

The GDPR also gives data subjects the right to bring civil claims for compensation for damage or distress suffered as a result of breaches. From a regulatory perspective, data protection authorities will (i) have clear audit rights (only patchily available under the Directive), and (ii) as under the Directive, will have various powers to compel compliance with the GDPR. Member states will remain free to impose criminal penalties for breach.

Brexit

The GDPR will almost certainly take effect before the UK leaves the EU, which is unlikely to be before March 2019. The government has made it clear that it will do nothing to step back from the GDPR. UK businesses will therefore need to comply with the GDPR in full, at least during the period between May 2018 and Brexit.

The government has proposed a Data Protection Bill to substantially implement the GDPR into UK law. It is therefore very likely that UK data protection law post-Brexit will be closely based on the GDPR.

This does not mean that Brexit will be unproblematic from a data privacy standpoint. The post-Brexit UK may be regarded by the EU as “inadequate” for data transfer purposes until the European Commission determines that UK law ensures an adequate level of protection for EU personal data. Such an “adequacy” decision is not guaranteed; however, implementing the GDPR under the proposed Bill is a positive step towards obtaining such a decision.

Unless a transitional or permanent solution to these problems is found through Brexit negotiations, businesses will need to find alternative means to justify future data sharing between the EU and the UK (e.g. standard form data transfer agreements). As such, both fund managers and private equity portfolio companies should take Brexit into account in assessing their international data transfer strategies.

08.

New EU Beneficial Ownership Regimes

Tom Taylor, BVCA

08. New EU Beneficial Ownership Regimes

Tom Taylor
BVCA

Firms in the UK will be familiar with the "PSC" regime, which last year introduced new public disclosure requirements for people with significant control over UK entities. The PSC regime implemented an element of the EU's Fourth Money Laundering Directive (4MLD) that requires EU legal entities to maintain registers of their "Ultimate Beneficial Owners" (UBOs). For political reasons, the UK's domestic PSC regime was implemented ahead of the June 2017 deadline for implementation of the full 4MLD framework across the EU and additional requirements were introduced to comply with 4MLD, such as the extension of the PSC regime to Scottish Limited Partnerships. The remaining EU Member States have now begun to implement similar regimes, in order to bring their national laws in line with the requirements of the Directive.

BVCA members should note that 4MLD is a framework that gives Member States considerable discretion on the detail of local rules governing UBO registers. Key areas of national divergence include the precise implementation timeframe, the level of disclosure expected, and the degree of public access to disclosed information that is required. Firms should therefore expect to receive different disclosure requests from entities established in different EU Member States, and should seek local advice in relation to these requests, as well as on the register-keeping obligations of EU entities they control.

09.

Case Law update November 2017

Ed Griffiths, DLA Piper

09. Case Law update November 2017

Ed Griffiths
DLA Piper

Applying the principle of informal unanimous consent (the Duomatic principle)

In *Randhawa and another v Turpin and another*, the Court of Appeal considered whether the principle of informal unanimous consent (ie the *Duomatic* principle) could be invoked to validate an appointment of administrators made by the sole director of the company whose articles had a quorum of two for board meetings, in circumstances where 75% of the share capital was held by the sole director and the remaining 25% was registered in the name of a dissolved Isle of Man company.

The High Court had found that the appointment was valid on the basis that the articles had been informally amended by a consistent course of conduct by its shareholders which sanctioned the exercise of all the directors' powers by a single director, and that the consent of the sole director as the only existing registered shareholder was sufficient to trigger the Duomatic principle.

The Court of Appeal unanimously held that the administrators' appointment was invalidly made. The court concluded that the *Duomatic* principle was incapable of applying here because the principle requires the assent of all the registered shareholders who have the right to attend and vote at a general meeting of the company, and one of the registered shareholders, as a dissolved company, was incapable of consenting. The dissolved company's assent could also not be inferred for the purposes of engaging *Duomatic* by looking to what those who may have previously had an interest in it may or may not have thought.

Share option agreement: duty to exercise discretion reasonably

In *Watson and others v Watchfinder.co.uk Limited*, the High Court considered the interpretation of a clause in a share option agreement which provided that the option could only be exercised with the consent of a majority of the company's board. When the option holders tried to exercise the options, the company refused to issue the shares, stating that its directors did not consent. The option holders sought specific performance of the allotment of shares. The court rejected the company's argument that the board had an unconditional right to veto the exercise of the options. Such an interpretation would make the options meaningless as the grant of shares would be entirely within the gift of the company and the position would be no different from when any person sought to buy shares in the company.

However, the clause could not be disregarded entirely. It clearly was intended to act as some sort of limit. The court decided that the company had a duty to exercise its discretion reasonably, following a proper process and taking into account all the material points and not taking into account irrelevant considerations. Here, however, the court concluded there had been no proper exercise of the discretion. There had barely been any considered exercise by the board of the discretion at all and the company therefore could not demonstrate that it had discharged its duty properly. Accordingly, the court granted specific performance to the option holders.

Share purchase agreement: further assurance and implied duty to co-operate

In *Takeda Pharmaceutical Company Limited v Fougera Sweden Holding*, the High Court considered whether the seller had an express or implied duty under a share purchase agreement to provide the purchaser with certain information for the purposes of negotiating the settlement of an ongoing tax dispute that the target company had with the tax authorities, for which the seller had given the purchaser a specific indemnity. The seller's liability under the indemnity was capped at €75mn and fell away completely unless the dispute was resolved before the sixth anniversary of completion. The purchaser contended that it could negotiate a settlement of the tax dispute before the indemnity expired and reduce the target's liability if the seller provided it with certain information about the seller's ultimate investors. Whilst the agreement did not contain an express clause requiring the seller to provide this information, the purchaser argued that the agreement imposed positive obligations on the seller to provide the information and a negative obligation not to wrongfully prevent the purchaser from getting the information. These obligations arose either under the further assurance clause, as they were reasonably necessary to give effect to the agreement, or because there were implied terms in the agreement to that effect.

The court rejected the purchaser's arguments. On the proper interpretation of the agreement, there was nothing in it that required the seller to provide the requested information, and so access to the information was not reasonably necessary to give full effect to the agreement. There was nothing for the further assurance clause to bite on. The court also found that implying the terms the purchaser had suggested was not necessary to render the agreement workable and there was no room to do so having regard to the express terms of the agreement.

This case therefore illustrates the need to include detailed claims handling/assistance provisions in relation to issues covered by indemnities.

Entrepreneurs' relief: shares with no dividend rights are "ordinary share capital"

In *HMRC v McQuillan*, the Upper Tribunal considered whether redeemable shares with no right to a dividend were shares with a right to a dividend at a fixed rate of zero per cent and therefore not "*ordinary share capital*" for the purposes of entrepreneurs' relief. Section 989 of the Income Tax Act 2007 provides that "*ordinary share capital*" in relation to a company, means "*all the company's issued share capital (however described), other than capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the company's profits*".

In this case, Mr and Mrs M claimed entrepreneurs' relief in respect of their disposals of their ordinary shares in a company. That claim was refused by HMRC, on the basis that neither of Mr and Mrs M had, throughout the period of one year ending with the date of the share sale, held at least 5% of the "*ordinary share capital*" of the Company. That conclusion followed from the view of HMRC that 30,000 redeemable shares that had no right to a dividend, and were held by other shareholders of the company, were part of the company's "*ordinary share capital*". The First-tier Tribunal held that a class of shares which had no right to a dividend should be regarded as having a right to a dividend at a fixed rate of zero per cent, so the 30,000 redeemable shares were therefore fixed rate share capital rather than "*ordinary share capital*". This meant that Mr and Mrs M each held more than 5% of the "*ordinary share capital*" and so were entitled to entrepreneurs' relief. However, the Upper Tribunal disagreed and held that a right to a dividend of zero was not a right to anything at all. It therefore concluded that the redeemable shares did constitute "*ordinary share capital*" and Mr and Mrs M didn't meet the 5% "*ordinary share capital*" requirement for entrepreneurs' relief.

Construction of pre-emption rights in articles

In *Cosmetic Warriors Ltd v Gerrie*, the Court of Appeal determined the correct construction of pre-emption provisions in two companies' articles of association.

Both sets of articles restricted the right of shareholders to sell their shares and granted pre-emption rights to other shareholders, enabling them to purchase the shares at a "*prescribed price*" which, in default of agreement, would be determined by independent accountants. If the shares were not taken up at that price by the other shareholders, their owner could transfer them "*to any person at any price (not being less than the prescribed price)*". The respondents were minority shareholders and wished to sell their shares. A dispute arose concerning the valuation. At first instance the judge held that the accountants had to conduct their valuations on the basis of a pro rata proportion of the value of the whole equity of each company, rather than on the basis of the price which might be achieved for the shares given their status as a minority shareholding. The issues in the appeal were (i) the correct basis of valuation; and (ii) whether the "*any person*" to whom the vendor could transfer the shares was restricted to a natural person, excluding a corporate transferee.

The Court of Appeal held that the judge had determined the correct basis of valuation. The companies argued that the starting point in English law was a presumption in favour of a construction which put a realistic value on the shareholding, rather than a construction favouring an artificial value based on the overall value of the company as a whole. However, the court found that there was no presumption one way or another. The parties might well have intended the valuation to reflect the value of the vendor's proportional stake in the business as a whole, regardless of the size of his shareholding. There was no substitute for looking at the language actually used in order to ascertain what the parties intended. The starting point was the definition of the "*prescribed price*" because that was the only place where the nature of the exercise to be performed by the accountants was stated. The prescribed price was stated to be such sum "*per share*" according to valuation of the company on a going concern basis. The reference to a going concern had to mean valuing the company as a whole. Once that value had been found, the prescribed price would be calculated by ascertaining a price per share on a pro-rata basis. The language pointed clearly away from valuing the shares to be transferred as a block. It only made sense if the value per share was derived from the value of the company as a whole.

Ordinarily, the word "*persons*" included a corporation. Another provision of the articles gave the company the right to sell "*to any person or company of whom or which ... it shall approve*". The words "*of whom or which*" indicated that the differentiation was clearly intentional because the draftsman had had inanimate corporations in mind. However, the court held that it was not appropriate to carry this distinction forward to the pre-emption provision to limit the words "*any person*" (which would normally be unrestricted) to natural persons only. Much clearer language would be needed to restrict the normal meaning of "*any person*", given the general principle that shares, as items of personal property, were prima facie freely transferable.

Voting right provisions in pre-Companies Act 2006 articles and written resolutions

In *Puzitskaya and others v St Paul's Mews (Islington) Ltd*, the High Court considered whether a provision in a company's articles of association which provided for members to have particular voting rights in general meetings could also be construed so as to apply where a vote was on a written resolution. The claimants argued that:

- although section 284 of the Companies Act 2006 provides that members have one vote per share on a vote on a written resolution, that was displaced by the provision in the articles that stated one vote per member; and
- although the relevant provision in the articles only referred to general meetings, not written resolutions, the articles had been drafted before the Companies Act 2006 allowed for majority votes on written resolutions, so they should be construed as making provision for the written resolution procedure as well as for general meetings.

The court held that when construing constitutional documents, the court was entitled to look at subsequent changes in circumstances. However, that approach did not permit the court to rewrite or improve the wording, so as to extend it beyond its ordinary and natural meaning. Where the parties had used unambiguous language, the court had to apply it. It was therefore held to be clear that the relevant provision in the articles did not apply to written resolutions.

In light of this case, companies should check their articles where the voting rights are intended to differ from the position set out in the Companies Act 2006 to ensure that the voting right provisions cover votes both at general meetings and on written resolutions.

Access to register of members: proper purpose

In *Burberry Group PLC v Richard Charles Fox-Davies*, the Court of Appeal considered whether a request for access to a company's register of members was made for a proper purpose under section 117 of the Companies Act 2006. Here, the request was made by a business tracing lost members of companies which, for a fee or commission, reunited them with their shares. The company, which retained its own tracing agent (whose fees were more favourable to located shareholders than the appellant's), had refused to comply with the access request. The court found that the registrar had been entitled on the material before him to conclude that the appellant's purpose was not proper.

The Court held that the onus was on the company to show that access was not sought for a "*proper purpose*". The court would find the purpose as a fact, on a balance of probabilities, on the evidence before it and then had to make an evaluative judgment as to whether it was a proper or improper purpose in the conventional way, using the context and on a case by case basis. The propriety of the purpose had to be assessed objectively. To be a proper purpose, it could be, but did not have to be, in the interests of the company or its shareholders. The intended use of the information and the way in which it was to be used, as well as the characteristics of the requester, were relevant only if they justified a finding of a different or additional purpose to the one stated by the requester.

Death of sole director-shareholder and rectification of register of members

In *Kings Court Trust Ltd and others v Lancashire Cleaning Services Ltd*, the court held that although it would not normally order rectification of a company's register of members to add executors in the place of a deceased member until the executors had proved their title by obtaining a grant of probate, in exceptional circumstances, where the death of the sole director-shareholder led to the company having no acting officers and delay would damage the company's prospects of survival, rectification could be ordered in the absence of a grant of probate.

Note that the problems faced in this case by the company, which was left without a surviving director or shareholder, could have been avoided, and an order for rectification of the register would have been unnecessary, if the company's unmodified Table A articles had included provisions allowing the executors to appoint a director or to enter their own names on the company's register of members in place of the deceased sole director-shareholder. Companies should therefore ensure that their articles contain provisions (such as in article 17(2) of the model articles for private companies) which enable continuity of management in the event of their sole director-shareholder's death.

Limited role for contra proferentem rule in commercial contracts

In *Persimmon Homes Ltd and others v Ove Arup & Partners Ltd and another*, the Court of Appeal confirmed that the *contra proferentem* rule (requiring any ambiguity in an exemption clause to be resolved against the party who put the clause forward and relied on it) now has a very limited role in relation to commercial contracts negotiated between parties of equal bargaining power. The rule should only be applied in cases of genuine ambiguity as to meaning. It stated:

"*In major construction contracts the parties commonly agree how they will allocate the risks between themselves and who will insure against what. Exemption clauses are part of the contractual apparatus for distributing risk. There is no need to approach such clauses with horror or with a mindset determined to cut them down. Contractors and consultants who accept large risks will charge for doing so and will no doubt take out appropriate insurance. Contractors and consultants who accept lesser degrees of risk will presumably reflect that in the fees which they agree.*"

This decision highlights the increasing judicial willingness to adopt a more modern approach to the interpretation and enforcement of exclusion clauses agreed by commercial parties of equal bargaining power.

10.

Failure to prevent the facilitation of tax evasion: an update

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10. Failure to prevent the facilitation of tax evasion: an update

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Introduction

The new offence of failure to prevent the facilitation of tax evasion came into force on 30 September 2017. It has caused some concern within the investment fund industry given its potentially wide remit and the increased media attention to any suggestion of impropriety in relation to tax. However, some comfort has been gained from discussions between the BVCA and HMRC, during the course of which the anticipated approach of HMRC should serve to secure a sensible interpretation of the law.

Actual offence

The new offence is contained in what is now the Criminal Finances Act 2017 and is, in reality, two separate offences. The first is the offence of failure to prevent the facilitation of UK tax evasion (the "Domestic Offence"). The second is the offence of failure to prevent facilitation of foreign tax evasion (the "Foreign Offence"). However, they have some key features in common. In each case, a body corporate or a partnership (referred to as a "relevant body"), whether established for business or non-business purposes, may be prosecuted for failure to prevent the facilitation of tax evasion if:

- a person ("T") evades tax;
- an associate ("A") of the relevant body criminally facilitates that evasion while acting in the capacity of an associate of the relevant body; and
- the relevant body is unable to show they had in place "reasonable prevention procedures" (or that it wasn't reasonable for prevention procedures to be in place).

The offences are both strict liability offences and thus require no knowledge or intention on the part of the relevant body. T need not have been prosecuted for evasion and A need not have been prosecuted for criminal facilitation. T (or A) may in fact have made a disclosure of the evasion (or criminal facilitation) in order to secure immunity from prosecution or similar. However, T and A must nonetheless have committed the offences in question before any offence can be committed by the relevant body. As discussed further below, both evasion and facilitation have a high standard of knowledge and intention – thus, relevant bodies will not be exposed based on e.g. mere error by A or by T arranging his affairs in a tax-efficient manner not amounting to evasion. Strict liability may attach to the new offences but those which are necessarily committed first have a high degree of culpability.

A person is an "associate" of the relevant body if the person "performs services for or on behalf of" that body (for example, as an employee, agent or subcontractor). The substance of the relationship will be considered, not just the form. A relevant body will not, however, commit the offence if the associate commits the offence of facilitation on a personal basis – the action must be in their capacity of an associate of the relevant body. The concept of a person who "performs services for or on behalf of" the organisation is intended to be broad in scope, to embrace the whole range of persons who might be capable of facilitating tax evasion whilst acting on behalf of the relevant body. This is important in considering the potential scope of the offence and addressing reasonable prevention procedures discussed below.

The Domestic Offence can be committed by a relevant body irrespective of where they are established or carry on business, and whether or not any part of the criminal facilitation took place in the UK. In fact, wholly non-UK conduct by a non-UK entity can be included, if it is directed at the evasion of UK tax. In such cases, the government still considers that the new offence can be tried by the courts of the UK. Again, while broad, this is necessarily subject to a defence based on reasonable (or even no) procedures. HMRC does appear to accept that it may not be reasonable for relevant bodies in such cases to even be aware this offence exists.

The Foreign Offence can only be committed where:

- the relevant body is established in the UK, or carries on any part of their business in the UK (for example, through a branch); or
- any part of the criminal facilitation took place in the UK.

Once again, this gives the law a broad extra-territorial scope: a body corporate may fall within scope and be capable of committing the Foreign Offence merely by virtue of having a UK branch, even if that branch is not itself involved in the facilitation or the evasion. Equally, technically speaking, a one-off business visit to the UK by an associate of an entity with little UK connection could result in the Foreign Offence being committed if the associates facilitates foreign evasion during the visit.

For the Domestic Offence, a UK tax evasion offence is the common law offence of cheating the public revenue and an offence in any part of the United Kingdom consisting of being knowingly involved in, or taking steps with a view to, the fraudulent evasion of tax. In the case of the Foreign Offence a foreign tax evasion offence has two elements. First, it must be criminal offence under the law of the foreign territory relating to tax imposed under the law of that country, and second, it must involve conduct which would be regarded by the UK Courts as an offence of being knowingly concerned in, or taking steps with a view to, the fraudulent evasion of tax (if it had occurred in the UK).

Facilitation, as anticipated, is subject to a wide interpretation. The person must do an act anticipating that it will assist another person to evade UK tax. Examples in the draft HMRC guidance (the “Guidance”) of activities potentially amounting to facilitation (if conducted with the necessary intention to assist the evader), include:

- Delivery and maintenance of infrastructure - for example, trust and company formation and setting up and maintaining bank accounts.
- Financial assistance – helping an evader move money around, providing banking services.
- Acting as a broker or conduit – i.e. arranging access to others in the supply chain.
- Providing planning advice.

It is a complete defence to both of the offences if the relevant body can prove that, when the tax evasion facilitation offence was committed, either (a) the relevant body had in place reasonable prevention procedures; or (b) in all the circumstances it was not reasonable to expect the relevant body to have any prevention procedures in place.

Prevention procedures are those designed to prevent associates from committing tax evasion facilitation offences. As with the Bribery Act, the Guidance states that the formulation of measures to prevent facilitation should be informed by the following six principles:

- Risk Assessment;
- Proportionality of risk-based prevention procedures;
- Top level commitment;
- Due diligence;
- Communication (including training); and
- Monitoring and review.

The Guidance recognises that procedures may leverage existing controls. However, the appropriateness of controls will need to be informed by a considered risk assessment, and simply adding "and tax evasion" to a long list of diverse prohibited activities under existing ethics policies is not expected to be sufficient.

Unlimited fines can be imposed upon conviction and orders for confiscation of assets may also be made. In order to encourage self-reporting by relevant bodies, Deferred Prosecution Agreements (DPAs) will also be an available tool for prosecutors. DPAs, which are a mechanism for resolving certain types of offending by corporate entities, involve charges being laid but the prosecution being suspended for a specified period provided certain agreed conditions are met.

Application to private equity

The question of how this legislation applies to the private equity fund industry is highly dependent upon the private equity house involved but a number of key areas can be identified as requiring general attention.

Portfolio companies themselves need to consider the rules on a separate basis but the interaction between the private equity house and the portfolio company results in the potential for some ambiguity and areas of risk. For example, a director of a portfolio company who is an appointee of the private equity house arguably has a dual potential capacity as an "associate". Clearly they are a director of the portfolio company but they may also be acting as an associate of the private equity house in relation to their director activities. Thus, reasonable prevention procedures may need to consider this aspect of the role of employees and other possible "associates". Discussions with HMRC have elicited the understanding that, in cases in which an individual can have more than one capacity, the focus is on their capacity when committing the offence. The issue is to ascertain the entity on whose behalf they are acting at the time of committing the actions amounting to the offence.

The breadth of the term "associate" and its extension to those performing services for an entity is also something private equity houses will also need to consider. Helpfully, HMRC have suggested in discussions that only in exceptional circumstances would a portfolio company itself be regarded as an "associate" of the private equity fund or manager. It would appear that the expectation is that the facilitator is invariably an individual. Nonetheless, although portfolio company issues are unlikely to result in issues for the private equity house in terms of the new offence, it is important from the point of view of potential future sale to ensure that portfolio companies have their own reasonable procedures in place.

International issues may also require careful review. It is fair to say that most UK private equity houses have some kind of international activity or presence and this, again, could present issues. If an individual employee of a private equity house is also a board member or employee of e.g. the Luxembourg General Partner of a fund, they could be considered to be acting in that capacity in certain circumstances and, given the breadth of the Domestic Offence, any activity in Luxembourg by an associate of the Luxembourg GP might still be subject to the new rules. Thus, reasonable prevention procedures need to take this into account and may need to extend to the GP itself.

The concept of what amounts to "reasonable" in terms of prevention procedures will require some internal analysis and this will need to be considered on a case-by case basis. However, some assistance has been obtained in the course of HMRC discussions. Risk assessment is regarded as extremely important. Indeed, taking fewer steps to address the offence, but targeting those steps to risk areas may even be looked upon more favourably than a non-targeted approach. Accordingly, private equity houses who have not yet reached the point of having procedures in place should focus their attention on risk assessment. High level commitment is another area emphasised by HMRC. It is crucial that senior personnel are seen to endorse and support steps taken to address the new offence.

Actual risk assessment documents and related procedures will vary according to the size and complexity of the organisation in question.

Further help

The BVCA website has the BVCA guidance and slides from the seminars on a dedicated page:

www.bvca.co.uk/Policy/Tax-Legal-and-Regulatory/Matters-on-our-agenda/Taxation/Failure-to-prevent-the-facilitation-of-tax-evasion-offence

11.

BEPS Action Point 2: Hybrids

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Background

The OECD/G20 report of 2015 "Neutralising the effects of hybrid mismatch arrangements", summarises the purpose of OECD BEPS Action 2 as follows:

"*Hybrid mismatch arrangements exploit differences in the tax treatments of an entity or instrument under the laws of two or more tax jurisdictions to achieve a double non taxation, including long term deferral. These types of arrangement are widespread and result in substantial erosion of the taxable base of the countries concerned*"

In response to the OECD BEPS Action 2, the UK introduced the anti-hybrid legislation in TIOPA 2010 Part 6A, which came into force on 1 January 2017.

Overview of the rules

The UK anti-hybrids legislation targets mismatches arising from arrangements which have hybrid characteristics and achieve an asymmetric tax outcome. Examples include:

- Financial instruments which produce a deduction for payments for the payer, with no corresponding recognition of income for the other party.
- A company being regarded as opaque in one jurisdiction, but tax transparent in another, resulting in either a double deduction, or a deduction in the payer with no recognition of income for the other party.

As well as applying to arrangements which directly involves a UK company (e.g. where the UK company is either the payer or payee in respect of the hybrid financial instrument), the rules also apply where the effect of a hybrid arrangement is being "imported" into the UK, for example via a plain vanilla loan, to the extent the hybrid effect that is being imported is connected to a UK deduction and is not counteracted in the relevant territory (Chapter 11).

The rules are not limited to a situation where there is an absolute mismatch outcome, but also counteract arrangements that contain the relevant features and where the deferral of income recognition exceeds 12 months.

The legislation is complex and is set out in 14 Chapters, containing nine rules and a Targeted Anti Avoidance Rule (TAAR). The rules are expected to apply after transfer pricing and relevant anti-avoidance rules and before the new corporate interest restriction (CIR) rules.

HMRC published draft guidance and ran a consultation from 9 December 2016 to 10 March 2017. In total, 44 stakeholders (including the BVCA) responded to the draft guidance. Updated draft guidance spanning approximately 400 pages was published on 31 March 2017, which included updated examples and clarifications. However, due to the complexity of the rules there remain a number of areas of uncertainty.

A number of technical changes to the rules were announced in the Autumn Budget on 22 November to be introduced in the 2017/18 Finance Bill. In particular, the Government has confirmed our understanding of the rules in amending Chapter 7 of Part 6A to clarify the treatment of entities which are seen as hybrids by some investors, but as transparent by others. This change makes it clear that in such cases, any counteraction applied by the regime will be proportional to the investor's shareholding in the structure.

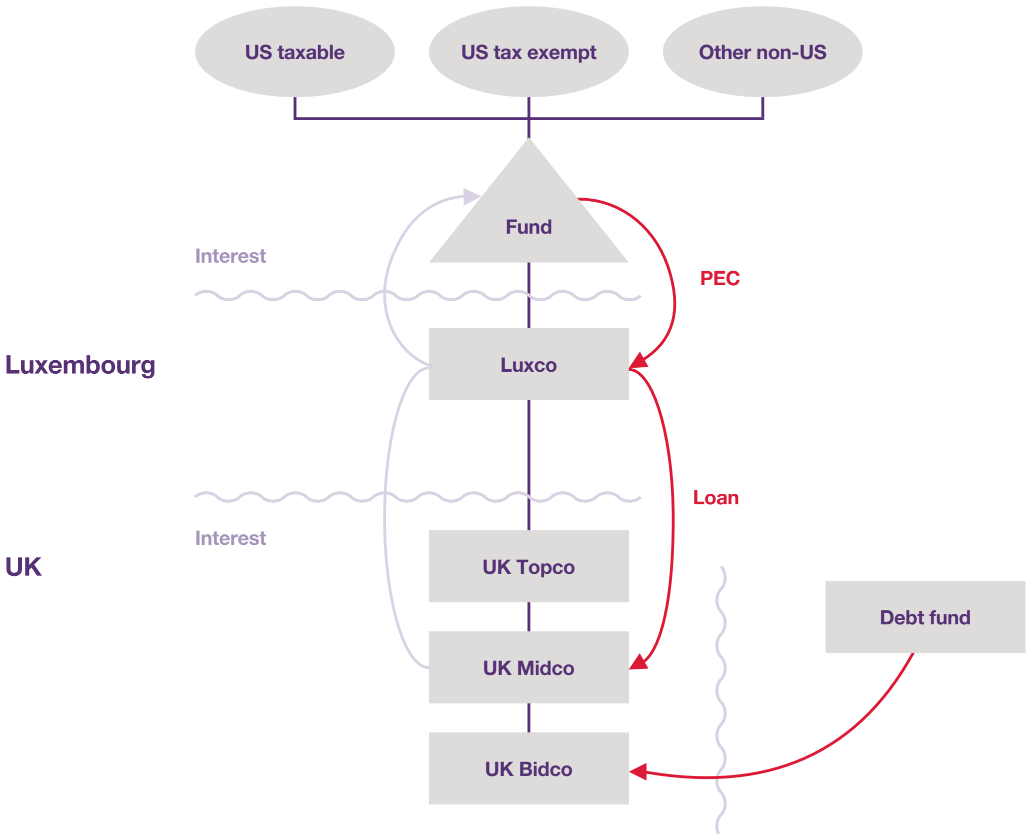
Application to Private Equity structures

Due to the wide application of the anti-hybrid rules, it is expected that they may apply to certain PE holding structures.

An example of type of PE structure impacted by the rules, could be a structure involving a hybrid instrument, for example a Preferred Equity Certificate (PEC), between the PE fund and a Luxembourg holding company. The funding is then on-lent from the Lux Holdco into the UK holding structure as an ordinary loan, typically with interest accruing.
The PEC is treated as equity for US investors and debt for Luxembourg tax purposes. Consequently, for US taxable investors, they should only be subject to tax on the accrued interest when it is paid on exit (rather than taxed annually on the interest accrued). For the UK company that is the payer in respect of the loan to Luxembourg, the deduction can be taken on a current year basis and the expense used to offset profits via group relief. The structure therefore achieves a current year UK deduction and a deferral of tax on the accrued interest expense until exit for the US taxable investors.

As the PEC is treated as equity for US taxable investors and as debt for Luxembourg tax purposes, it is therefore likely to be a hybrid instrument for the purpose of TIOPA 259CB(2). Due to the PEC being used to finance a loan into the UK group, Chapter 11 of Part A TIOPA 2010 will apply as a consequence of the imported mismatch, as the mismatch outcome from the PEC is not expected to be counteracted in either Luxembourg or the US for the purposes of 259KA(7). An illustration of this example is included below:

Figure 1.



Counteractions for imported mismatches

Calculating the counteraction

The relevant legislation is at 259KA, which contains the imported mismatch conditions and refers to the relevant hybrid mismatch definition at 259CB. The relevant guidance is provided in INTM559300.

To the extent that the deduction claimed by Luxco (i.e. the PEC in this example) exceeds the receipt brought into charge by the US investors from the hybrid financial instrument, there will be a mismatch outcome.

Where the funds obtained under the instrument are passed to the UK via a loan under which interest payments are made and deductions claimed (the imported mismatch payments) then, for the purpose of calculating the amount to be counteracted under 259KC, the imported mismatch subject to a counteraction will correspond to the proportion of the PEC payments funded by the imported mismatch payment. In the example illustrated at Figure 1, this would equal the entire mismatch outcome, as all the funds have been on-lent to UK Topco.

The question is therefore, what approach is the UK company required to follow in determining the proportion of the receipt from the hybrid instrument that results in a mismatch and what evidence will HMRC expect to be available to support the apportionment used in calculating the UK imported mismatch for the purpose of 259KC?

In practice, each fund investor will be entitled to their proportional share of the income on the PEC under the terms of the partnership agreement. Whilst the PEC is likely to be a hybrid instrument for US investors (taxable and tax-exempt), for many other non US investors, the return on the PEC will be taxed as interest income on an accruals basis. Consequently, for non US investors, there is typically no deferral of ordinary income, no reduced rate and therefore no mismatch outcome in respect of this proportion of the relevant payment.

Such funds will normally have a diverse mix of investors. A significant proportion of the investors are typically exempt investors (e.g. pension funds), or fund investors from outside the US, both of whom do not typically benefit from a mismatch tax outcome as a consequence of the hybrid nature of the instrument. Additionally, it is common that “fund of funds” will also be investors, which will in turn have their own investors, participating through transparent fund vehicles.

In the example above, the rules would require that quantum of the counteraction under Chapter 11 to be calculated based on the amount of the relevant mismatch, by reference to the principles in Chapter 3, as imported mismatch relates to a mismatch payment due to a hybrid instrument. When determining the extent of the mismatch under Chapter 3, it may appear sensible to use “a just and reasonable” approach in determining the proportion of the mismatch. However, the draft guidance does not currently directly state that this approach can be used for the purpose of calculating the extent of the mismatch (and consequently the extent of the counteraction under 259KC), suggesting that the actual outcome must be determined in each case regardless of the practical difficulties. Given this point is likely to be relevant to a substantial number of UK PE owned portfolio companies, which will need to calculate this counteraction, the BVCA has requested additional clarification is included in the guidance.

Ordinary income to tax exempt investors

As discussed above, it is common for a substantial amount of the UK investment from Private Equity funds to be sourced from tax exempt investors, in particular from pension funds. Tax exempt investors achieve no tax benefit from the use of the hybrid, as to the extent there is a mismatch outcome, it primarily arises from the tax exempt status of the investor, rather than the hybrid instrument.

For the purpose of the rules, a mismatch arises to the extent the “relevant deduction exceeds the sum of the amounts of ordinary income”. The rules apply to treat a mismatch as arising from the hybridity of a financial instrument, where it would have arisen by reason of that hybridity, had the tax exempt entity not been entitled to a beneficial tax treatment and had instead been taxable in that region. Therefore the amount attributable to a pension fund (in a region where a hybrid mismatch would otherwise arise), will only be accepted as outside the scope of the rules, where that amount is regarded as having been included as “ordinary income” (for the purposes of 259CB(2)). It is therefore necessary to consider whether income received by a tax exempt investor should be considered “ordinary income” as defined at 259BC.

It has been confirmed in discussions with HMRC that 259BC operates such that a receipt, which is not brought into account for the purposes of calculating income or profits on which a relevant tax is charged by a tax exempt body, by virtue of the body’s tax exempt status or otherwise, should not be recognised as “ordinary income” of the tax exempt body.

Consequently, the proportion of the relevant deduction in respect of income arising to a tax exempt investor (that is a payee in respect of the hybrid instrument in a territory where a mismatch would arise), will be treated as contributing to the mismatch outcome for the purpose of 259CB(1), and the counteraction would be applied on that basis, in accordance with 259CD(2). Therefore, the counteraction in the above example will also include the amount of the interest expense that indirectly matches the receipt by the US tax exempt investors.

It has been highlighted to HMRC that this appears to be an extension that was not intended by the OECD in their Report of 5 October 2015, where at Para 13 it states that: “While cross-border mismatches arise in other contexts (such as the payment of deductible interest to a tax exempt entity), the only types of mismatches targeted by this report are those that rely on a hybrid element to produce such outcomes”. HMRC’s response was that they believe it is compatible and ultimately no counteraction would arise if hybrids were not included within the structure.

Adjustments in light of subsequent events

Helpfully, HMRC have confirmed verbally that whilst Chapter 12, which deals with deductions subsequently arising late at 259LA(1)(a), does not specifically refer to Chapter 11 (imported mismatches) it should apply to imported mismatches on a similar basis as it applies to hybrid instruments (259CD). Consequently, in the Luxembourg example, where there has been a counteraction to disallow the UK interest expense for a proportion of the funding, a deduction should become available (subject to other relevant rules), when the receipt is ultimately taxable for the relevant fund investors (i.e. on exit).

Application of the rules to otherwise unconnected debt providers

There has been uncertainty over whether the anti-hybrid rules could apply to otherwise unconnected debt providers. This issue is particularly relevant in PE transactions, where different types of debt providers may be involved.

Broadly, the issue could arise for example where a debt fund (separate from the PE fund), is providing a normal commercial loan to fund the transaction and it is reasonable to suppose that within the debt fund there are hybrid entities or instruments, that may give rise to a mismatch outcome, such that the corresponding interest receipt is not being fully taxed within the relevant period (and therefore may become subject to the imported mismatch rule as above).

For the Debt fund loan to be within the rules, it is necessary for the Debt fund and the relevant PE fund payer company to be "related" (for Chapter 3), or in the same "control group" (for Chapter 11) under the relevant tests, or where the arrangement is considered as a "structured arrangement".

Whilst it may appear that there should be no "structured arrangement", on the basis that the possible mismatch outcome for the debt provider was not linked to the subsequent loan, the rules are widely drafted and the guidance follows a broad interpretation. It is therefore typically necessary to consider the other tests.

Related parties / Control group

The risk of being considered to be a related party or within the same control group arises due to the uncertainty on how the 25%/50% investment tests are interpreted. In particular, this is because the tests are widened to situations where;

- If the whole of the borrowing entity's income is distributed, the lender would receive 50% or more of the distributed amount; or
- In the event of a winding up, the lender would receive directly or indirectly 50% or more of the assets available for a distribution.

There is no definition of "distribution" in the Anti-Hybrid Rules or TIOPA 2010 and so it would appear reasonable that its ordinary meaning should be used. Based on the definition of distributions under Part 23 CTA 2010, assuming the debt is on commercial terms and is not an equity like security, it would be assumed that a "distribution" means a payment made in respect of shares in a company, and would therefore not include amounts applied in repayment of loans or payment of interest. Consequently, this would mean that ordinary creditor rights, of the sort which could result in a Debt fund receiving proceeds on a winding up, should not be treated as assets available for a distribution, and any other payments made to the Debt fund should also not be included as income distributed, for the purposes of 259ND(4). However, neither the rules nor the guidance, as currently drafted, specifically confirm this interpretation.

The uncertainty is increased as, unlike with the Group Relief provisions within Part 5 CTA 2010 (section 151) and the Corporate Interest Restriction rules to be included within Part 10 TIOPA 2010 (section 464), the legislation does not restrict the test to "equity holders".

Acting together

The potentially broad application of the definition of "acting together" in section 259ND(7) to an otherwise unconnected Debt fund has given rise to further uncertainty.

In the above example, the Debt fund does not hold any equity (or warrants to acquire equity) in the UK group and is not connected (absent the "acting together" provision) to the PE Fund, who hold the shares in the group. The Debt fund, the PE Fund and UK Topco will however typically be parties to various agreements in respect of UK Topco which sets out the rights of the PE Fund as shareholders, together with various protections for the Debt fund, which ensure that the actions of shareholders do not increase the credit default risk.

Section 259ND(7)(c) states that the Debt fund is to be taken to “act together” with the PE fund in relation to UK Bidco, if they are party to any arrangement, that it is reasonable to suppose is designed to affect the value of any of the PE funds rights or interests in UK Bidco. Given the very broad drafting, there is a risk that shareholder agreements of the sort outlined above could be viewed as an “arrangement” under these rules.

The effect of this in the example at Figure 1, would be that the Debt fund would be taken to have all of PE funds rights and interests in UK Bidco and consequently the investment conditions in the control group test would be met. The Debt fund would therefore be treated as being in the same “control group”.

The implication of being in the same control group is that it would also be necessary to consider whether the Debt fund may be subject to Chapter 11 (imported mismatches) to the extent there is any hybridity in its structure, notwithstanding that the Debt fund is an independent third party, providing finance to the group in the same way as a bank. Consequently, borrowers using debt fund financing may be subject to the additional cost and complexity of having to consider the Anti-Hybrid Rules and may potentially be subjected to a restriction on interest deductions.

Representations have been made by the BVCA in respect of both of these points, broadly requesting that draft guidance be updated to reflect that where a third party debt fund is providing normal loan finance, it should not be subject to the anti-hybrid rules as a consequence of either the application of the related party, control group, or acting together tests.

Conclusion

The final version of the updated HMRC guidance was due to be released at the end of September 2017, but as at the date of writing has yet to be issued. Consequently, there remain a number of areas of uncertainty. It is recommended that the impact of these anti-hybrid rules is considered carefully, wherever hybrid entities or instruments are present in a structure.

12.

BVCA Jargon Buster

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12. BVCA Jargon Buster

The BVCA works across a wide range of areas and engages with a number of government departments and international bodies from across the world. We are conscious that many acronyms are used and for the benefit of our members, some of these are explained below.

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UK Government Bodies	
HMT	**HM Treasury** HMT is the government's economic and finance ministry. It is responsible for a number of policy areas that impact the private equity and venture capital industry, including financial regulation and taxation.
HMRC	**HM Revenue & Customs** HMRC is a non-ministerial department of the UK Government responsible for the collection of taxes, the payment of some forms of state support, and the administration of other regulatory regimes.
BEIS	**Department for Business, Energy and Industrial Strategy** BEIS is the government ministry responsible for business, industrial strategy, science, innovation, energy and climate change policy. The BVCA has worked with BEIS and its predecessor, BIS, on a number of areas, including company law, corporate governance, cutting red tape and the register of people with significant control.
DExEU	**Department for Exiting the European Union** DExEU is responsible for coordinating and overseeing the UK's negotiations for leaving the European Union.
FCA	**Financial Conduct Authority** The FCA is the conduct regulator for the financial services industry in the UK, and the prudential regulator for those parts of the sector that are not regulated by the Prudential Regulation Authority, including private equity and venture capital.
PRA	**Prudential Regulation Authority** The PRA is part of the Bank of England. It is the prudential regulator for banks, building societies, credit unions, insurers and major investment firms.
FPC	**Financial Policy Committee** The FPC is part of the Bank of England responsible for identifying and monitoring systemic risks to the UK financial system, including levels of leverage and debt. It can make recommendations to the FCA and PRA to introduce changes to mitigate risks to the financial system.
FRC	**Financial Reporting Council** The FRC is the UK's independent regulator for promoting high quality corporate governance and reporting. The FRC sets standards for corporate reporting and audit practice and monitors and enforces accounting and auditing standards. It also oversees the regulatory activities of the professional accountancy bodies.

The European Union	
European Council	The European Council consists of the heads of government of the 28 EU Member States. It sets the general political direction of the EU and establishes its priorities by adopting "conclusions" following quarterly summits. It is not one of the EU's legislating bodies, and should not be confused with the Council of the European Union (see below).
European Commission	The European Commission is the executive branch of the European Union. It has the sole power to initiate legislative proposals, which must be approved by both the European Parliament and the Council of the European Union (see below). While the Commission does not have the power to introduce or veto amendments to legislation, if it objects to amendments unanimity is required in the Council for the amendments to be adopted. This, along with the Commission's agenda setting power, makes it a key player in negotiations over EU laws.
Council of the European Union	The Council of the European Union is one of the European Union's two 'co-legislators', along with the European Parliament (see below). It consists of government Ministers from the EU Member States who meet to discuss, amend and adopt laws proposed by the European Commission (see above).
European Parliament	The European Parliament is, along with the Council of the European Union, one the EU's co-legislators. It is composed of 751 elected MEPs organised into 8 recognised political groupings. The Parliament can approve and amend proposals made by the Commission, but must agree a final text with the Council in order for a proposal to become law.
Trialogue	Trialogues are informal meetings of representatives from the European Parliament, the Council of the European Union and the European Commission. They are used to agree amendments to legislation that are acceptable to all three parties.
ESAs	**European Supervisory Authorities** The European Banking Authority ("EBA"), the European Insurance and Occupational Pensions Authority ("EIOPA"), and the European Securities and Markets Authority ("ESMA") are the three European Supervisory Authorities. While national supervisory authorities remain in charge of supervising individual financial institutions, the ESAs aim to improve the functioning of the internal market by promoting harmonised European regulation and supervision by developing Level 2 regulation (secondary legislation) and guidance. They are accountable to the European Parliament and the Council of the European Union.
ESMA	**European Securities and Markets Authority** ESMA, based in Paris, is the ESA (see above) responsible for promoting stable and orderly financial markets. ESMA's remit includes markets and securities regulation, asset management and investor protection.

EIOPA	**European Insurance and Occupational Pensions Authority** EIOPA, based in Frankfurt, is the ESA (see above) responsible for the supervision of the insurance and pension sectors, and ensuing that policyholders are sufficiently protected.
EBA	**European Banking Authority** The EBA, based in London, is the ESA (see above) responsible for the banking sector. Its overall objectives are to maintain the EU's financial stability and to safeguard the integrity, efficiency and orderly functioning of the banking sector.
RTS	**Regulatory Technical Standards** Level 1 (primary) legislation may empower the Commission to adopt technical standards in the form of RTS. The RTS are prepared by the relevant ESAs, and submitted to the Commission, which has 3 months to adopt the RTS or send them back to the ESAs for amendment. Once adopted by the Commission, there is a 1 month window (which may be extended to 3 months) for the European Parliament and the Council to object to the proposals.
ITS	**Implementing Technical Standards** Level 1 (primary) legislation may empower the Commission to adopt technical standards in the form of ITS. The ITS are prepared by the relevant ESAs, and submitted to the Commission, which has 3 months to adopt the RTS or send them back to the ESAs for amendment. Unlike RTS (see above), ITS are not scrutinised by the Parliament or the Council.
ECB	**European Central Bank** The ECB is the central bank for the Eurozone. It is responsible for monetary policy in the Eurozone, as well as identifying and monitoring systemic threats to financial stability such as excessive levels of leverage and debt.
EIB	**European Investment Bank** The EIB is the EU's development bank, owned by the Member States. It uses its creditworthiness to borrow at low rates on international capital markets and works closely with other EU institutions to finance projects that contribute to EU policy objectives.
EIF	**European Investment Fund** The EIF is a specialist provider of risk finance to SMEs across Europe. Between 2011 and 2015 the EIF invested €2.3bn into UK venture capital and growth funds. It is majority owned by the EIB (see above).

The European Private Equity and Venture Capital Industry	
AFIC	**L'Association Française Des Investisseurs Pour La Croissance** AFIC is the French private equity and venture capital trade association.

BVK	**Bundesverband Deutscher** The BVK is the German private equity and venture capital trade association.
Invest Europe	**Invest Europe** Invest Europe, formerly EVCA, is the pan-European trade body for private equity and venture capital.
EPER	**European Private Equity Roundtable** EPER is the Invest Europe committee that represents large buyout houses. It feeds into the policy work of Invest Europe and the PAE (see below).
PAE	**Public Affairs Executive** The PAE is the industry's strategic decision-making body for EU-level public affairs. It consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations, including the BVCA. The PAE makes policy submissions on behalf of the European private equity and venture capital industry to the European Institutions and international bodies.
PSC	**Professional Standards Committee** The PSC is the Invest Europe Committee that helps to ensure that proper professional standards are maintained across the European private equity and venture capital industry through its member firms' support of an industry-led Code of Conduct.
Rep Group	**European Representative Group** The Rep Group consists of Invest Europe and the private equity and venture capital associations from individual EU Member States, including the BVCA. It provides a forum for coordinating action at a Member State level and feeds into the work of the PAE (see above).
TLRC	**Tax Legal and Regulatory Committee** The TLRC is the Invest Europe Committee that deals with tax, legal and regulatory matters affecting the European private equity and venture capital industry. The TLRC provides expert advice to the PAE, of which its chair is a member, and drafts position papers and consultation responses for approval by the PAE.

International	
IOSCO	**International Organization of Securities Commissions** IOSCO the international body that brings together national securities regulators, and develops, implements and promotes adherence to international standards for securities regulation. The FCA (see above) is the UK member. It works closely with the G20 and the FSB (see below) on the international regulatory agenda.

FSB	**Financial Stability Board** The FSB is the international body responsible for promoting financial stability. It identifies and monitors global systemic risks, and works with national authorities and international standard setting bodies to respond to threats as they arise. The FSB is chaired by Bank of England Governor, Mark Carney.
OECD	**Organisation for Economic Co-operation and Development** The OECD is an intergovernmental economic organisation designed to promote policies that will improve economic and social well-being. It has a wide-ranging remit including trade and investment, economic growth, employment, health, education and tax. The OECD is responsible for the Base Erosion and Profit Shifting (BEPS) initiative which looks to tackle tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations.
G20	The G20 is the central forum for international cooperation on financial and economic issues made up of 19 countries and the European Union. Much of the global tax transparency agenda and post-financial crisis regulatory framework originated in discussions between finance ministers, central bankers and heads of government at a G20 level.
FATF	**Financial Action Task Force** FATF is an inter-governmental body established to set global standards for combating money laundering, terrorist financing and related threats to the integrity of the international financial system. FATF also monitors the progress of its members in implementing the measures it recommends.

Other Trade Associations and Industry Bodies	
ABI	**Association of British Insurers** The ABI is the trade body for the insurance industry and providers of savings products and services.
AIC	**Association of Investment Companies** The AIC represents the mutual funds industry as well as some venture capital trusts.
AIMA	**Alternative Investment Management Association** AIMA is the global trade associations for the hedge fund and private debt fund industry.
AFME	**Association for Financial Markets in Europe** AFME is the trade body for participants in wholesale financial markets. Primarily leading European and global investment banks as well as other significant capital market players.
BBA	**British Bankers' Association** The BBA is the trade association for the UK banking sector.

EFAMA	**European Fund and Asset Management Association** EFAMA is the trade association for the traditional European investment management industry.
IA	**The Investment Association** The Investment Association is the trade body that represents the UK's traditional investment management industry.
ILPA	**Institutional Limited Partners Association** ILPA is the global industry association for private equity Limited Partners. It aims to promote best practice in the private equity industry, and publishes standardised industry documents and reporting templates.
JMLSG	**Joint Money Laundering Steering Group** The Joint Money Laundering Steering Group is made up of the leading UK trade associations in the financial services Industry. Its aim is to promulgate good practice in countering money laundering and to give practical assistance in interpreting the UK Money Laundering Regulations. This is primarily achieved by the publication of industry-specific guidance.
OTS	**Office for Tax Simplification** The OTS is an independent office of HM Treasury and gives independent advice to the government on simplifying the UK tax system.
PERG	**Private Equity Reporting Group** The PERG is the independent body that monitors conformity with the Walker Guidelines on transparency and disclosure within UK private equity industry.PERG also makes recommendations to the BVCA on improvements in the levels of openness and communication amongst the largest private equity houses in the UK.
WMA	**Wealth Management Association** The WMA is the UK trade association for wealth managers, private banks and stockbrokers.

US regulation	
Investment Adviser	**Investment Adviser** Any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities (Section 202(a)(11), Investment Advisers Act of 1940).
RIA	**Registered Investment Adviser** An investment adviser that is registered under the Investment Advisers Act with the SEC (see below) and/or state securities authorities, as applicable.

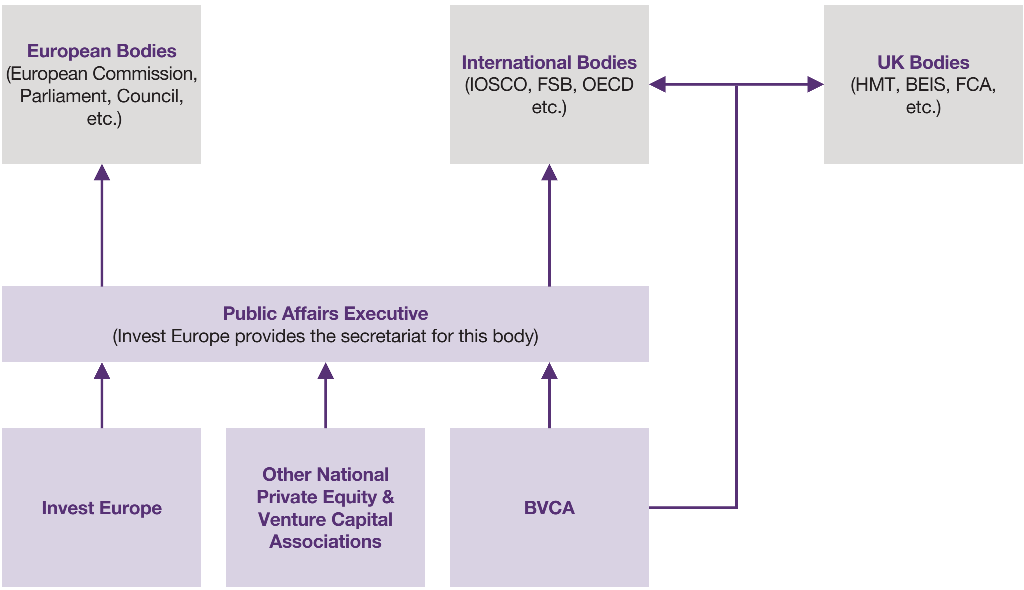
ERA	**Exempt Reporting Advisor** An investment adviser exempt from registration with the SEC due to falling within the Venture Capital Fund, Foreign Private Adviser or Private Fund Adviser exemptions, among others.
FATCA	**Foreign Account Tax Compliance Act** FATCA is a 2010 United States federal law to enforce the requirement for United States persons including those living outside the U.S. to file yearly reports on their non-U.S. financial accounts to the Financial Crimes Enforcement Network ("FINCEN").
SEC	**Securities and Exchange Commission** The SEC is an independent government body in the US, and its aim is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

How the BVCA influences policy

The diagram below maps how the BVCA works with its European partners to influence the domestic and international tax, legal and regulatory agenda.

The private equity industry's primary decision-making body for political engagement at a European level is the Public Affairs Executive (PAE), which brings together practitioners from across Europe, representatives from national venture capital associations and Invest Europe—the pan-European industry body. The BVCA, AFIC (the French trade association) and the BVK (the German trade association) have permanent seats on the PAE, and Invest Europe provides the secretariat. Other national trade associations have a rotating seat filled by the country holding the EU presidency, and also feed into decision making through the European Representative Group—a deliberating body composed of representatives of all the national private equity and venture capital associations and Invest Europe.

The BVCA engages directly with policy makers in the UK and international bodies outside of the European Union. However, our close relationship with our colleagues in Europe ensures that our positions are joined up, and the European industry speaks with a unified voice.


European Bodies
(European Commission, Parliament, Council, etc.)
International Bodies
(IOSCO, FSB, OECD etc.)
UK Bodies
(HMT, BEIS, FCA, etc.)
Public Affairs Executive
(Invest Europe provides the secretariat for this body)
Invest Europe
Other National Private Equity & Venture Capital Associations
BVCA

British
Private Equity &
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Association

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