British Private Equity & Venture Capital Association

Technical Bulletin

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

May 2018 ////

Contents

Please feel free to contact the Policy Team for further information on any of the matters raised in this document.

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 in May and November each year.

The uncertainty surrounding Brexit continues to feature in the BVCA's policy work, and we have been providing monthly updates via the online Brexit Bulletin. 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, Chris Elphick and Tom Taylor.

The Taxation Committee has responded to a number of consultations from HMRC and HMT, two of which are outlined by Mark Baldwin and Rhiannon Kinghall-Were in their article. Matthew Saronson gives an overview on the 2017 changes to US tax legislation including the taxation of carried interest and the cut in the rate of corporation tax. The tax section concludes with an update on UK legislation regarding hybrid entities and the BVCA engagement up to this point from Russell Warren, John Cox and Simon Page. The committee has also been engaging with HMRC and HMT on a number of other areas over the last six months, including the consultation on VAT Grouping and FATCA reporting for UK firms. The committee has recently published a template to assist members in carrying out a risk assessment of an asset management business pursuant to the corporate criminal offence of failure to prevent the facilitation of tax evasion. We are continuing our discussions with HMT on the impact of the carried forward loss restriction on general partner companies.

The Legal and Accounting Committee has been working on reforms to corporate governance requirements in the UK. In her article, Victoria Sigeti provides an update on the reporting requirements likely to impact private equity-backed companies and the BVCA's work in the coalition developing corporate governance principles. In the case law update, Thomas Laverty gives an overview of relevant English court judgements issued in the past six months. Amy Mahon and Tamsin Collins outline the potential effects on transactions of the Government's national security and infrastructure investment review. To conclude, Jonathan Wood and Camilla Barry summarise the proposed reforms to protect defined benefit pension schemes, following the Government's recent white paper. Over the past six months, the committee has also responded to proposals to streamline energy & carbon reporting in the UK following the planned abolition of the CRC Energy Efficiency Scheme in 2019.

The Regulatory Committee has been analysing the potential impact on BVCA members of a wide range of UK and EU regulatory developments, including the impact of the PRIIPs regulation on fund managers' marketing to retail investors. This regulation came into force this year and is considered in the article by Ed Kingsbury. Paul Ellison looks at the second stage of the FCA's extension of the UK Senior Managers and Certification Regime to our industry, dealing with the practical implementation of the new rules. Finally, Tim Lewis discusses the European Commission's proposed changes to the AIFMD and EuVECA marketing rules included in a new regulation covering the cross-border distribution of private investment funds. The committee has also been supporting the BVCA's work on Brexit and a future relationship with the EU, and developing an industry position in response to EU proposals for a new prudential regime for investment firms. In addition, the committee is supporting the BVCA's role in the FCA's Institutional Disclosure Working Group, which is producing a fees and charges reporting template for the asset management industry.

Amy Mahon
Chair, Legal & Accounting Committee

Mark Baldwin
Chair, Taxation Committee

Tim Lewis
Chair, Regulatory Committee

Gurpreet Manku
Deputy Director General & Director of Policy, BVCA

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. We would also like to welcome new members to our committees.

	New members on our committees	Members who stepped down
Legal & Accounting Committee	**Liz Judd** (STAR Capital) **Nick Reid** (Carlyle)	**Ian Roberts** (Permira) **Robin Bailey** (Pantheon) **Geoff Bailhache** (Blackstone) **Trudy Cooke** (Terra Firma)
Taxation Committee	**Paul McCartney** (EY)	**Paul Warn** (EY)

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

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

With best wishes,

Amy Mahon

Chair,
Legal & Accounting Committee

Mark Baldwin

Chair,
Taxation Committee

Tim Lewis

Chair,
Regulatory Committee

Gurpreet Manku

Deputy Director General & Director of Policy, BVCA

Legal & Accounting Committee

Amy Mahon (Chair)	Clifford Chance
Julie Bradshaw (Vice-Chair)	DH Private Equity
Alastair Richardson	3i
Ashley Coups	EY
Daniel Parker	Synova Capital
Ed Griffiths	DLA Piper
Ed Hall	Goodwin
Garrath Marshall	Deloitte
Geoff Kittredge	Debevoise
Graham Hislop	Montagu
Iain Bannatyne	KPMG
John Atherton	Ares Management
John Heard	Abingworth
Jonathan Wood	Weil
Liz Judd	STAR Capital
Nick Reid	Carlyle
Richard Mcguire	PwC
Sally Roberts	Accel
Stephanie Biggs	Travers Smith
Thomas Laverty	Kirkland & Ellis
Victoria Sigeti	Freshfields Bruckhaus Deringer
Tamsin Collins (secondee)	Clifford Chance

Regulatory Committee

Tim Lewis (Chair)	Travers Smith
Rachel Thompson (Vice-Chair)	Bridgepoint
Andrew Lewis	ICG
Babett Carrier	Cinven
Christopher Crozier	Permira
Ed Kingsbury	Dechert
James Smethurst	Freshfields Bruckhaus Deringer
John Decesare	3i
John Morgan	Pantheon
Lindsay Hamilton	Livingbridge
Louise Dumican (on maternity leave, **Matthew Cottrell** covering)	Carlyle
Mark Howard	KKR
Neel Mehta	DWS Private Equity
Paul Cook	YFM Equity Partners
Paul Ellison	Macfarlanes
Simon Powell	Advent International
Callum Burgess (secondee)	Travers Smith

Taxation Committee

Mark Baldwin (Chair)	Macfarlanes
Abigayil Chandra	Deloitte
Alexander Cox	Ashurst
Alexandra Hone	ICG
Anthony Stewart	Clifford Chance
Caroline Conder	LDC
Clare Copeland	Carlyle
Craig Vickery	Exponent PE
David Hewitt	Grant Thornton
Dominic Spiri	Terra Firma
Federico Saruggia	Permira
Fiona Cooper	Starwood
Gareth Miles	Slaughter & May
Graham Iversen	Greenberg Traurig Maher
James Pratt	BDO
Jenny Wheater	Linklaters
Jill Hardie	SL Capital Partners
Jill Palmer	3i

John Cox	KPMG
Jonathan Page	PwC
Maria Carradice	Mayfair Equity Partners
Matthew Saronson	Debevoise
Michael McCotter	DH Private Equity
Paul Cunningham	Helios Investment Partners
Paul McCartney	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
Rhiannon Kinghall Were (secondee)	Macfarlanes

01.

Brexit update

Gurpreet Manku, BVCA
Chris Elphick, BVCA
Tom Taylor, BVCA

01. Brexit update

This article provides an overview of developments in the Brexit negotiations, and the BVCA's work on key priorities for our industry, since the November 2017 edition of this Bulletin.

Gurpreet Manku
BVCA

Chris Elphick
BVCA

Tom Taylor
BVCA

Developments in the negotiations

Since my last update, the UK and EU negotiators have reached agreement in principle across the three areas under consideration in Phase I of negotiations. These were protecting the rights of EU citizens in the UK and UK citizens in the EU; the financial settlement; and the framework for addressing the unique circumstances in Northern Ireland. Phase II of the Brexit negotiations commenced in 2018 on the transitional period and a framework for the future UK-EU relationship.

In March 2018, the UK and the EU agreed the legal text for the Brexit transition period, which will last from 29 March 2019 to 31 December 2020. The agreement provides for a "standstill" as regards regulation. Whilst the UK will no longer be a member of the EU's decision-making bodies, there will be a "Joint Committee" where the UK can raise concerns about new EU legislation.

Progress has been made on a draft Withdrawal Agreement that translates the matters agreed during Phase I into legal terms. This includes a set of proposals for the outstanding withdrawal issues such as those on citizens' rights and the Irish border.

The European Union (Withdrawal) Bill is still making its way through Parliament, and the Government suffered a defeat after MPs voted in favour of an amendment to give Parliament a "meaningful vote" on the Withdrawal Agreement. A number of amendments were also proposed by the House of Lords relating to membership of the Customs Unions and the EEA. The Government also announced a new bill in November 2017 - the Withdrawal Agreement and Implementation Bill will give legal standing to the separation from the EU and major policies set out in the Withdrawal Agreement and transition period would be directly implemented into domestic law by primary legislation, not by secondary legislation under the EU (Withdrawal) Bill.

In May the Scottish Parliament voted to withhold consent from the EU (Withdrawal) Bill due to differences over the devolved powers that could return to Holyrood (rather than Westminster) after the UK leaves the EU. Technically this will not stop the legislation being passed, but it is another political issue for the Government to navigate over the next few months. A recently announced white paper is expected to be published ahead of a key EU Summit in June and will include "detailed, ambitious and precise explanations" of the UK's position. It will cover customs and the future relationship between the UK and EU over the security, financial services, aviation and fisheries sectors.

At the time of writing this piece, the Government is reviewing options for customs arrangements with the EU that would avoid a hard border with Ireland. The preferred "maximum facilitation" proposal utilises technology to streamline customs checks, and the "customs partnership" means collecting tariffs on the EU's behalf for goods intended for countries in the EU customs union. Both options would give the UK the ability to negotiate its own trade deals. It is worth noting that both proposals have already been rejected by the EU and without a solution to the Irish border issue, it is unlikely the framework for a future relationship with the EU will be agreed before the end of the summer.

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 issues with current visa processes and areas to consider as part of a new migration system. EU net migration continues to fall according to the Office for National Statistics and to levels last seen in 2012. The number of EU citizens coming to the UK (220,000) decreased by 47,000 over the year to September 2017. The number leaving the UK (130,000) is the highest level recorded since 2008.

The Government has published a policy paper on EU citizens arriving in the UK during the transition period after Brexit. EU nationals who arrive in the UK during this time will be eligible for indefinite leave to remain, which means that free movement of people could effectively continue until the end of the transition period. The Government has also updated its advice for EU citizens currently in the UK and the essential information for UK nationals living in the EU.

The timing of the Government's delayed white paper on migration is still unclear.

Patient Capital

A key Brexit priority for the BVCA is to ensure that the UK venture and growth capital industry continues to attract funding from institutional investors. In recent years, the European Investment Fund has been a significant investor in this part of the market and we have lobbied Government to ensure this funding continues through the British Business Bank's programmes. The Government's Patient Capital Review (covered in more detail in previous Technical Bulletins) and Industrial Strategy recognised the need to stimulate innovation and growth in the post-Brexit economy.

A consultation, *Financing Growth in Innovative Firms*, was launched in August 2017 to explore ways to improve the flow of patient capital. Venture capital schemes such as Enterprise Investment Scheme ("EIS"), Seed Enterprise Investment Scheme and Venture Capital Trusts, were considered as part of the review. The Government published its response to the consultation at Autumn Budget 2017, announcing an action plan to unlock £20 billion of investment over the next ten years and this has been welcomed by the BVCA and the industry.

The BVCA is working with the Government and the British Business Bank ("BBB") on the review's outcomes:

- Managed Funds Programme – The BVCA and the BBB hosted a joint roundtable in March with managers to discuss a new £500m private sector fund of funds programme that will seek to draw in institutional capital to the UK's venture and growth capital markets. A request for proposals was launched in May.
- Patient Capital Fund – HMT is leading on the creation of the £2.5 billion patient capital fund that will be a subsidiary of the BBB. This will house the VC Catalyst programme which covers venture and growth funds. The mandate of the programme is expected to be expanded to include listed vehicles and co-investment opportunities.
- Pensions Task Force – The BVCA is a member of a HMT taskforce looking at investment into patient capital and how to tackle barriers holding back Defined Contribution pension savers from investing in illiquid assets.
- EIS knowledge intensive fund consultation – We have responded to a HMT consultation on the capital gap that knowledge-intensive companies face. The consultation explores possible options for an EIS fund structure aimed specifically at investment in knowledge-intensive companies.

- Advance assurance process – The BVCA has highlighted concerns about delays with HMRC's advanced assurance process for the schemes and we understand waiting times have started to decrease. Discussions with HMRC and HMT are ongoing on how the process can be streamlined.
- International promotion – The BVCA joined a trade trip to Tokyo organised by the Department for International Trade ("DIT"). DIT has a venture capital team focussed on promoting investment into the UK market.
- Research – The BBB, BVCA and Diversity VC launched a new study at the BVCA's Breaking Barriers Diversity Forum in May to examine diversity in venture capital investments.

Planning for Brexit and comments from regulators

Private equity and venture capital 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. The BVCA has been in regular dialogue with the FCA and HMT about how our members are planning for Brexit and the impact of developments in the EU. These developments include the opinions published by the European Securities and Markets Authority ("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 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 broader asset management industry, as well as private equity, has commented on the need to maintain the current delegation model and we are responding to the increased scrutiny it is coming under. This includes 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. ESMA has sought to clarify that its opinions "do not call into question the delegation model". The FCA has also stated it saw "no real justification for unnecessarily complicating rules around delegation". HMT, in its latest Investment Management Strategy, has committed to "ensuring that the delegation model remains the global norm".

The FCA and the Bank of England ("BoE") issued statements in March 2018 welcoming the agreement reached on the terms of an implementation period. The FCA confirmed that funds currently benefiting from an EU passport need not apply for authorisation at this stage. Their statement notes that the implementation period would permit funds to continue to benefit from passporting between the UK and EEA until the end of December 2020, adding that UK firms and funds passporting into the EEA should discuss with their relevant EU regulator the implications of a transitional period for their contingency planning. The FCA intends to continue to cooperate closely with the home state regulators of EEA firms and the European Supervisory Authorities, in particular to address any risks to consumer protection and financial stability. In light of the agreement at the EU Council, the BoE considers it reasonable for firms currently carrying on regulated activities in the UK by means of passporting rights, to plan that they will be able to continue undertaking these activities during the implementation period in much the same way as now. The BoE further notes that the UK Government has committed to bring forward legislation, if necessary, to create temporary permission regimes to allow relevant firms to continue their activities in the UK for a limited period after withdrawal, and that this provides confidence that a back-stop will be available in the event that the Withdrawal Agreement is not ratified.

A future trade deal for financial services – mutual access

In separate speeches delivered in March 2018, the Prime Minister and the Chancellor signalled their support for a future financial services relationship with the EU built on mutual access. The Prime Minister highlighted that passporting would end, but argued that the UK and EU should establish the ability to access each other's markets, based on maintaining the same regulatory outcomes over time, with a mechanism for determining proportionate consequences where they are not maintained. The Chancellor called for continued close collaboration on cross-border financial services, and set out how a future partnership in financial services may be structured. A future relationship would follow the principle of mutual recognition and reciprocal regulatory equivalence, rather than the EU's established third-country equivalence regime. The speech envisaged a partnership under which there would be continued close supervisory co-operation. Although the UK would not be part of the EU's supervisory agencies, a close working relationship could cover market abuse, transaction reporting, and stability monitoring, as well as prudential concerns about individual firms.

These comments follow the detailed proposals published by the International Regulatory Strategy Group (an industry advisory body to the City of London Corporation and TheCityUK). The BVCA is a member of the IRSG and is currently reviewing how these proposals would impact our members in practice.

Member briefings

Our Brexit Portal 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.

The BVCA Brexit Bulletin is 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. Politics is still driving the negotiations. For political analysis and commentary from our Director General, please sign up to his weekly email, BVCA Insight.

The BVCA continues to host member breakfasts and briefings to discuss Brexit and please refer to our events calendar.

02.

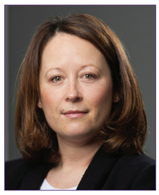
Round-up of recent tax developments impacting the PE industry

Mark Baldwin, Macfarlanes
Rhiannon Kinghall-Were, Macfarlanes

02. Round-up of recent tax developments impacting the PE industry

Taxing gains made by non-residents on UK real estate

Mark Baldwin
Macfarlanes



Rhiannon Kinghall Were
Macfarlanes

At the 2017 Autumn Budget, the Government announced that from April 2019 non-residents holding UK real estate will be subject to UK tax on their gains. This is a major change to the way in which UK real estate will be taxed.

UK capital gains tax ("CGT") has already been extended to certain non-residents holding residential property in recent years; however this new extension will bring almost all non-resident owners of UK land within the scope of UK tax on their gains, and will remove a key tax benefit currently enjoyed by non-UK investors in real estate. The new regime is subject to consultation so much of the scope and detail is uncertain. However the Government has said that the core aspects are fixed.

This development will be of interest to BVCA members who raise funds to invest in businesses that hold significant amounts of UK real estate as fixed assets used in their business and pure real estate funds (i.e. funds which invest in real estate rather than an operating business which utilises real estate in its operations). The BVCA submitted a written response[1] to HMRC raising three key points confined to comments of concern to operators of private equity and venture capital funds.

BVCA consultation response

The first issue the BVCA raised in its response relates to the risk that the proposals could aggregate investors' interests in collective investment vehicles ("CIV"), such that the 25% connected persons test is breached. This means non-resident investors with a 25% or greater interest in the CIV will be subject to tax on their gains from investing in the CIV under the rules on indirect disposals.

Take for example a fund that invests in a property rich business, like a chain of restaurants. Investors will only suffer a tax liability under the new provisions if they have (or had within the five years leading up to the time of disposal) a 25% or greater interest in the business. The consultation document indicates that in determining whether the 25% ownership test is met it is proposed to add together the interests of related parties and to define a related party using the connected party test (in s1122 CTA 2010) supplemented with "acting together" rules modelled on the corporate interest restriction rules (s465(3) TIOPA 2010) "to include situations where persons come together as a group with a common object in relation to the envelope entity".

Because funds operated by private equity firms are typically structured as partnerships, all investors in these funds will be treated as "connected" because s1122 CTA 2010 provides that all the partners in a partnership are connected with each other. This means that, however small a non-resident investor's participation in a limited partnership fund, they will inevitably be brought within the charge to tax on indirect disposals in cases where the fund partnership has a 25% or greater investment.

To mitigate this scenario, the BVCA has recommended that persons are not to be treated as connected, acting together or otherwise have their interests aggregated by virtue of their participation in a collective investment scheme as defined in the Financial Services and Markets Act 2000.

[1] BVCA response to consultation on taxing gains made by non-residents on UK immovable property – available here

The second issue raised relates to the Substantial Shareholding Exemption (“SSE”). Broadly speaking, the SSE provides an exemption for chargeable gains arising on the disposal of shares by a company, provided certain conditions are met.

The consultation document indicated that, in appropriate cases, the SSE may be available to assist non-resident investors. Where a company has a 10% or greater interest in the share capital of a trading company or the holding company of a trading group and has done so for at least a year prior to the time of disposal, any gain arising on the disposal will be exempt from corporation tax. Recent changes have expanded the scope of the SSE, so that the SSE can apply where an investment company has a greater than 10% stake in a trading company or group and also to cases where a company owned by a qualifying institutional investor makes disposal of an interest in another company.

It is accepted that, because a company can meet the requirement (for a 10%+ interest in the company invested in) in paragraph 8, Schedule 7 TCGA 1992 by holding an “interest in shares” as well as outright ownership, a company which invests through a partnership can in principle qualify for the SSE on a gain arising from a disposal of a partnership’s investment in a trading company/group. However, it does not follow from this that the SSE is a solution that will benefit the private equity industry.

First, the SSE will not help investors which are not companies; the SSE is an exemption from corporation tax for companies, not from tax on chargeable gains more generally. Second, the SSE will not help the vast majority of investors in a limited partnership fund; very few investors will have a large enough interest in the fund to meet the 10% threshold. Third, investors with a large stake in a fund partnership will still struggle to reach the required investment level. This is because (following the fund model agreed in 1987 between the BVCA, the Department of Trade and Industry and the Inland Revenue (as they then were)) the economic terms of a fund partnership give a priority share of income and gains to the general partner to enable it to meet fund operating costs and give the fund manager (or individuals involved with the fund manager) a carried interest in the profits of the fund once a performance hurdle has been met.

This fluctuating economic “waterfall” can make it difficult for an investor (even one with a significant interest in the fund) to show that, throughout the period of a year up to the time of disposal, it would have been beneficially entitled to not less than 10% of the profits available for distribution to equity holders of the portfolio company. The economic arrangements in a fund would need to be changed significantly from the norm to enable an investor to establish a claim to the SSE even where the investor has a significant interest in a fund partnership.

To alleviate this situation, the BVCA recommends that gains arising to a non-resident on a disposal of an interest in a property rich vehicle should be exempt from tax if that vehicle is a trading company or the holding company of a trading group, regardless of the size of the non-resident investor’s interest and whether the investor is a company or no.

The third issue the BVCA raised is in relation to the compliance obligations the new regime may place on a fund manager/operator. If investors had tax reporting and payment obligations by virtue of participating in a fund imposed on them as the proposals suggest, the scale of these obligations could rapidly escalate and become unmanageable. The BVCA recommends HMRC seek some easements for the fund manager/operator. This is not a proposal suggesting that investors should be released from such obligations, just that fund managers are given an opportunity to discharge those obligations on behalf of investors without investors needing to be involved.

Next steps

The next stage of the policy process will be the publication of draft legislation, which we can expect at some point during summer 2018. The legislation is due to take effect from April 2019.

Tax avoidance involving profit fragmentation

Another measure that was first announced at the 2017 Autumn Budget is now under consultation[2]. This proposal seeks to prevent UK traders and professionals from avoiding tax by arranging their UK business profits to accrue to entities resident in territories where no tax, or only a low rate of tax, is paid. The consultation paper states that the aim of the proposed legislation will be to ensure that the amount of profit appropriate to UK business activity is taxable in the UK. As well as introducing a new basis of charge, and perhaps of greater concern to the industry, it is proposed that a taxpayer notification and advance tax payment regime will also be introduced as part of the new rules.

These proposals come despite the volume of legislation already at HMRC's disposal that can tackle profit fragmentation arrangements. Under current law, it is possible for some of the profits of funds owned by UK resident individuals operating within the UK to arise to non-UK corporate structures beneficially owned by such individuals, without those profits being subject to UK tax. However, the disguised investment management fee rules ("DIMF Rules"), transfer of assets abroad rules, transfer pricing rules and the general anti-abuse rule guidance ("GAAR") are likely to bite.

The effect of these rules is broadly that, for profits to arise to a non-UK manager company free from UK tax, the company must have a commercial purpose in the relevant non-UK jurisdiction, profits allocated to it must reflect the functions performed by it and (where there is a controlling shareholder) the company must be subject to corporate taxation (broadly) equal to 75% of the equivalent UK corporation tax liability to which a UK company would have been subject.

The introduction of legislation with taxpayer notification and an advance tax payment regime highlights HMRC's resolve to shift the burden to taxpayers. Not only does HMRC state in the consultation document that the existing measures "can be difficult to apply as it requires the gathering of large amounts of information, and the users or promoters of the arrangements may seek to delay matters by arguing that HMRC has no right to force the production of relevant information held offshore", they also state that they want to strip the financial cash-flow benefit from some of these schemes.

The new measure will target arrangements if four conditions are met:

- **a.** There are profits attributable to the professional or trading skills of an individual (A) resident in the UK, whether A is trading as an individual or a partner, or conducting business through a company;
- **b.** Some or all of those profits ("alienated profits") end up in an entity Z which results in significantly less tax being paid on them than would have been paid had they arisen to A;
- **c.** A, or a connected person, or someone acting together with A or the connected person, is able to enjoy economic benefits from the alienated profits; and
- **d.** It must be reasonable to conclude that some or all of Z's profit is excessive having regard to the profit-making functions it performs with that excess being attributable instead to the connection between Z and A.

[2] HMRC Consultation: Tax Avoidance involving Profit Fragmentation – available here

The “significantly less tax” test within condition (b) involves a comparison with the tax rates suffered on the alienated profits. The condition will be met where Z is subject to 80% or less of the tax that would have been paid if the profits had arisen in the UK.

The “ability to enjoy” test within condition (c) proposes to borrow the “power to enjoy” test from the DIMF rules. This test will make it easier for HMRC to prove that the profits have been moved to an entity to which the UK individual or company concerned has a form of connection.

The “excessive profit” test within condition (d) will examine the substance of the arrangements and whether the sums paid are for genuine commercial arrangements in the local territory.
The consultation clearly states that this proposal has no intention of catching genuine business activities that are carried on in low tax territories for commercial reasons and with genuine commercial substance. While condition (d) will examine all of the facts around the arrangements and should therefore ensure the profits of legitimate commercial arrangements are not caught, many in the industry will be concerned that the notification and advance payment proposals are triggered only if conditions a, b and c are met (and not d).

It would appear that private equity fund managers will have to notify HMRC if it is operated out of a corporate structure established in a low-tax non-UK jurisdiction and beneficially owned by its UK resident principals, regardless of the substance of, or commercial justification for, that structure. This outcome appears to run contrary to the stated intention of the Government that commercial operations in low tax jurisdictions are not intended to be caught.

Private equity groups with UK resident fund managers operating through non-UK corporate structures may be concerned as to whether they may be caught by this new legislation, and thereby have profits of their non-UK corporate group (the entity Z) added to the profits of the UK entity.

A particular concern for private equity groups is that it appears that all “profits” arising within the entity “Z” (and not just trading profits) will be covered, meaning that, for example, “house carry” arrangements where groups hold a portion of fund carried interest through their manager corporate structure could be swept into the UK tax net for UK resident executives with power to enjoy such sums.

The consultation paper makes clear that the Government has no desire to affect genuine commercial arrangements with this legislation. It may therefore be the case that this initiative should not affect the operation of private equity groups in accordance with their current practice, with certain functions carried out in non-UK jurisdictions through a non-UK corporate structure owned by UK resident individuals. However, it will be necessary to monitor carefully the development of this initiative. The consultation closes on 8 June 2018 and the BVCA will be responding in due course.

03.

US Tax Reforms

Matthew Saronson, Debevoise & Plimpton

03. US Tax Reforms

Matthew Saronson
Debevoise & Plimpton

On 22 December 2017, President Trump signed into law the Tax Cuts and Jobs Act (the "Act"), enacting fundamental changes to many long-standing principles of the U.S. federal income tax system.

Highlights include:

- an immediate reduction of the corporate tax rate from 35% to 21%;
- a new limitation on the deductibility of business interest expense;
- the addition of a special deduction for individual taxpayers earning qualifying income from pass-through businesses;
- the introduction of broad base erosion avoidance measures and;
- changes to the taxation of foreign earnings.

Of most significance to BVCA members, however, are the changes to the required holding period for long-term capital gains received as carried interest and introduction of a new withholding requirement on certain sales by non-US investors of interests in partnerships that are engaged in a US trade or business (which has disrupted a certain amount of deal activity in the secondary market).

Carried Interest

During the Presidential campaign, President Trump expressed an intention to eliminate the so-called carried interest "loophole," and various proposals were made during the Obama administration and in Congress over the years to treat carried interest as ordinary income (taxed at 40.8% under the Act) rather than capital gain (which in the case of long-term capital gain realized by U.S. individuals is eligible for a reduced 23.8% rate of U.S. federal income tax). The Act takes a different approach and instead increases the holding period required for gains attributable to carried interest to be eligible for the reduced rate of U.S. tax on long-term capital gains from one year to three years, perhaps in recognition that the characteristics of carried interest are distinct from ordinary compensation income and that encouraging longer term investment is an important policy objective.

As most of a private equity fund's returns generally are capital gains and typically arise from assets held by the fund for three or four years or even longer, the carried interest from a typical private equity fund is generally taxable as long-term capital gains for U.S. federal income tax purposes in the hands of the recipients.

Under the new three-year holding requirement, capital gain relating to carried interest that arises after December 31, 2017 will be treated as short-term capital gain, taxed at the same rates as ordinary income, unless the asset generating the gain has been held by the fund for more than three years. (Note for this purpose that it is the fund's holding period in the asset, rather than the partner's holding period in the fund/carry partnership that is relevant.) The Act does not provide a grandfathering rule and makes no exceptions for capital gains relating to carried interest arrangements that were in place prior to December 31, 2017.

The new three-year holding period is similar to the changes made to the taxation of carried interest in the United Kingdom in 2016, but with one key distinction. Under the UK rules, the treatment of income received with respect to carried interest as ordinary income or capital gains depends on the average holding period of the assets of the fund giving rise to such income. Capital gains treatment will generally apply if the average holding period is 40 months or more and ordinary income treatment will generally apply where it is less than 36 months (average holding periods between 36 months and 40 months result in a blended treatment). In contrast, under the Act, the average holding period of the fund is not relevant and the holding period is determined separately for each deal.

The Act has no effect on the treatment of capital gains outside of the carried interest context. As such, sponsors (on their capital investment) and investors will continue to benefit from the reduced U.S. tax rate if the asset generating the gain has been held for more than one year (not three). This difference in the holding period requirement may give rise to conflicts between investors and sponsors because carried interest holders will be subject to tax at higher tax rates on early realizations, even if they would be in the investors' interests.

Withholding Tax on Sale of Partnership Interest

The IRS has historically taken the position that a non-U.S. seller of an interest in a partnership that is engaged in a U.S. trade or business is required to treat any gain from the sale of the interest as "income effectively connected with a U.S. trade or business" ("ECI Gain") to the same extent that the seller would have been allocated ECI Gain had the partnership disposed of all of its assets at fair market value. For non-U.S. sellers a lot is at stake: non-ECI Gains are generally exempt from U.S. tax, while ECI Gains are subject to U.S. federal income tax and require the non-U.S. seller to file a U.S. federal income tax return. The Act overturns a recent taxpayer court victory and codifies the IRS position. Moreover, it imposes a new 10% withholding requirement on the "amount realized" on the sale of the partnership interest if any portion of the gain is ECI Gain. As a further backstop to help ensure collection in the event a buyer does not withhold the required amounts, the Act requires the partnership to withhold any amounts that the buyer failed to withhold, plus interest, from subsequent distributions to the buyer.

Although the Act applies to transfers on or after 1 January 2018, it was not until 2 April 2018 that the IRS released Notice 2018-29 (the "Notice") clarifying the application of the rule to privately held partnerships. The Notice provides a number of exceptions and simplifications that taxpayers may rely on until new regulations are issued.

Exceptions to withholding

U.S. Sellers

Generally this may not be subject to withholding on the sale of a partnership interest by providing either a Form W-9 or a certificate of nonforeign status (similar to those used for FIRPTA). (Note, however, that it is not clear that a non-U.S. partnership with U.S. partners may pass through its W-9 forms may not be subject to withholding in connection with the sale of a lower-tier partnership interest.)

Foreign Sellers

Generally not be subject to withholding on the sale of a partnership interest if:

- *Seller Certificate:* The seller certifies no earlier than 30 days before the sale that it has been a partner in the partnership for all of the three prior taxable years and the partner's share of ECI for each of those years was less than 25% of its total share of income for such year.
- *Partnership Certificate:* The seller provides a certificate issued by the partnership no earlier than 30 days before the sale that certifies that the partnership's built-in gain that is ECI represents less than 25% of the total built-in gain. (Note, however, that the Notice indicates that the IRS intends to provide future guidance that will reduce both of the foregoing thresholds below 25%.)

- *No Gain or Nonrecognition Transaction:* The seller certifies that the sale of its partnership interest will result in no realized gain or that it is engaged in a nonrecognition transaction.

Amount of the withholding liability

Withholding is imposed on 10% of the “amount realized” on the sale of a partnership interest. Under the Act, the “amount realized” generally includes any cash and other proceeds plus the seller’s share of partnership liabilities. The Notice provides some helpful guidance on determining partnership liabilities. If the buyer is not provided with appropriate certification as to the amount of liabilities to be taken into account, the buyer must withhold all the proceeds.

Determining the Amount of Partnership Liabilities

- *Seller Certification:* A noncontrolling partner may certify (1) the amount of its liabilities based on information from its most recent Schedule K-1 for a partnership taxable year that has closed within 10 months of the date of the sale and (2) that it is not aware that its share of partnership liabilities has changed significantly.

(Note this rule is likely to provide little comfort in the private fund context because it is common for partnerships to significantly extend their tax filing deadlines, resulting in any Schedule K-1 received by the seller being stale.)

- *Partnership Certification:* A partnership may issue a certificate no earlier than 30 days before the sale that provides (1) the partner’s share of partnership liabilities, which may be the amount reported on the most recently prepared Schedule K-1 and (2) that the partnership does not have actual knowledge that the seller’s share of partnership liabilities has changed significantly (25% or less) since the certification.

Partnership level withholding

- The Notice suspends the application of the rule that requires the partnership to withhold on distributions to the buyer in the event the buyer failed to withhold.

Note that this will allow fund sponsors (for now) to be more flexible about permitting transfers because there is no residual liability for the partnership. Still, transfer agreements will need to be reviewed carefully to ensure that any withholding tax risk is allocated appropriately.

04.

Update on BEPS Action Point 2: Hybrids

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Background

The UK's "hybrid and other mismatches" rules have been in force since 1 January 2017 having been enacted in response to action 2 of the OECD's Base Erosion Profit Shifting ("BEPS") project "Neutralising the effects of hybrid mismatch arrangements".

The aim of the rules is to counteract "tax mismatches" which arise from arrangements with a hybrid element or which are designed to create that mismatch. For example they might prevent a UK company claiming a tax deduction if:

- **i.** it has checked the box for US tax purposes such that both it, and its US parent can claim a tax deduction for the same payment, or
- **ii.** the deduction arises from a payment under a financial instrument designed to deliver a tax deduction to the borrower without a corresponding taxable receipt for the lender.

The rules can also "import" mismatches that arise between two non-UK entities - for example a UK borrower may have a tax deduction denied on a payment of interest that is "funding" a mismatch between two non-UK entities.

As set out in the last BVCA Technical Bulletin[3], the rules are highly complex with advisers and BVCA members not all necessarily reaching a consensus on their application and the amount of information needed in order to take positions in self-assessment tax returns.

So where are we 16 months later? Are advisers and BVCA members now clear as to how the rules apply and the impact they may have? The short answer is "not entirely", but progress is being made. Proposed amendments to the legislation were published on 1 December 2017 and have since been enacted in the Finance Act 2018 which clarify some areas. HMRC also published updated guidance on 29 November 2017 (a mere 442 pages long) which contains some helpful amendments in terms of understanding HMRC's view of how the rules operate (but relate to the original version of the rules, not the amended version in the Finance Act 2018).

The aim of this bulletin is to update you on the latest thinking and market practice on some important areas of the rules.

Interaction with other rules e.g. transfer pricing

Surprisingly, there is still some uncertainty as to whether the hybrid rules should be applied before, after or at the same time as other rules that affect the deductibility of a payment e.g. transfer pricing and other domestic rules (unallowable purpose etc).

HMRC guidance (the November version) acknowledges that there is no priority order in the rules themselves and suggests that they should be considered "whenever a mismatch within the scope of Part 6A arises, unless the application of other rules removes the mismatch". This implies that other rules such as transfer pricing might be considered in priority, which has some logic as a payment under the hybrid rules is only a "payment" if it is deductible.

However, the water then becomes murky again, as the guidance goes on to consider an example that concludes a similar result occurs whether transfer pricing is considered before or after the hybrid rules. This is not necessarily the case. We have made this point to HMRC and asked them to change their guidance to make it clear as to their view of the order in which the rules apply.

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[3] BVCA Technical Bulletin: November 2017 – available here

For example, transfer pricing may conclude that a company can only support £200k of interest payments as deductible. The hybrid rules may conclude that 25% of deductible payments made by the same company are disallowed by reason of a hybrid mismatch e.g. because 25% of the receipts are not brought into account as ordinary income by reason of hybridity in the structure.

What if the company makes an interest payment of £1m? How much of that payment is deductible? If transfer pricing applies first the £1m reduces to £200k. The hybrid rules are then applied to the £200k and 25% is disallowed, leaving us with £150k of deductible interest. However, if the hybrid rules were applied first we would still have £200k of deductible interest (because the hybrid rules would reduce the £1m to £750k, which the transfer pricing rules would then reduce to £200k). If they are considered alongside one another, one might take the lesser of the two limits imposed by the two sets of rules – in this case the lower of £200k or £750k, and accordingly £200k of interest would be deductible.

As an aside it is worth noting one thing we do know, which is that the hybrids rules apply in priority to the corporate interest restriction. This makes sense, as the corporate interest restriction rules restrict deductible interest rather than denying it (and in theory at least this restricted interest could be reactivated to give a deduction in a later accounting period).

The reasonable to suppose test and filing your tax return

It is not unusual for a discussion on the anti-hybrids regime to revolve around the constitution of, and investors in, a particular fund given that some of the more difficult aspects of the regime can be found in the "imported mismatch" rules.

But it is important to remember that the anti-hybrid rules need to be operated by, and affect the tax position of, the portfolio company and not the fund.

To comply with the rules the legislation asks the portfolio company to consider whether it is "reasonable to suppose" that a prohibited mismatch has arisen such that an interest deduction should be denied for corporation tax purposes.

Note that the test is framed in a very particular direction. It does not ask whether it would be reasonable to take a deduction for a given interest cost but whether it would be reasonable to suppose that it should be denied. This begs a number of questions:

- **i.** do the rules require the portfolio company to ask its sponsoring PE House whether its structure gives rise to an "imported mismatch" when forming its reasonable supposition?;
- **ii.** what degree of information will the portfolio company need to receive to be comfortable that the supposition it is making is reasonable?; and
- **iii.** how should a portfolio company act when no information is forthcoming?

These questions imply that it is the anti-hybrids regime which specifically requires a portfolio company to make inquiry of its PE House in order to operate the rules. Arguably it is not the hybrid rules that imposes this obligation; rather it is the longstanding obligation on all taxpayers (currently contained in paragraph 1A, Schedule 25 Finance Act 2007) to complete their tax returns using reasonable care.

HMRC's guidance reflects this position noting at INTM551100 that "Parties to the transaction should take all reasonable actions to establish whether a mismatch is likely to arise, taking account of the relevant tax laws of the territories involved. It is not necessary for the parties to await final resolution of the relevant tax returns, *nor do the parties need to make disproportionate enquiries*" (the italicised words added by the November 2017 changes). This particular paragraph only applies to Condition C in Chapter 3 (financial instruments) and we have asked HMRC to update their guidance to clarify that this approach should be adopted in each of the other Chapters containing this test.

This suggests that where information is provided by the PE House through the filter of professional advisers, and absent an obviously manifest error, it should be sufficient for the portfolio company to adopt a filing position based on the information provided. Note, also, that deliberately supplying, or withholding, information from a taxpayer is an offence which is subject to a penalty (paragraph 1A Finance Act 2007). Care must therefore be taken by PE Houses when responding to such requests. An obvious potential trap may be to report a mismatch that does not properly reflect the current partnership sharing ratios e.g. if the carry has kicked in.

However, what should a portfolio company do if no information is forthcoming? This is a particularly hard case. Portfolio companies are unlikely to be comfortable filing on the basis that an absence of information permits them to always take a full deduction. Or in other words that, without any information, they cannot come to a view that a mismatch will arise even if the test is framed in this single direction. In practice, a portfolio company will have to take as reasonable an approach as it can with the information it does have, and should take professional advice.

Ultimately, the reasonable to suppose test needs to be judged on the facts and circumstances of each specific case but the inclusion of the "disproportionate enquires" limit in HMRC's revised guidance does provide a helpful clarification.

Third Party Debt

From a policy perspective it is arguably difficult to justify bringing third party arm's length debt into the anti-hybrids regime. But caught it is or, at least, could be.

This would arise where the third party debt provider is connected to the borrowing portfolio company or its sponsoring PE House. The connection test in this case is cast extremely widely adopting the "control group" concept (which is defined in section 259NB Taxation (International and Other provisions) Act 2010).

While much of the control group test turns on the holding of shares (which will be irrelevant for a third party debt provided in most cases), it is extended to arrangements where, very broadly, the PE House's rights in relation to its portfolio company are affected by the debt provider's rights. As noted above this appears to be a peculiar approach to adopt in relation to debt provided by a third party acting at arm's length.

However, the updated guidance provides some useful commentary in this respect. Very broadly the guidance notes that where the third party debt is "plain vanilla" with no equity component, the arrangement will only be caught if both the lender and borrower were aware that the debt arrangements were designed to give rise to a mismatch (a "structured arrangement" in the language of the rules). Earlier versions of the guidance had not included this key knowledge requirement on the part of the borrower in this particular part of the rules (chapter 11).

This is helpful as in practice a portfolio company will likely not know how a third party debt financier is itself structured or how it intends to treat the arrangement.

As a result, the market is becoming more comfortable with this fact pattern. That said, we feel the guidance could go further in helping portfolio companies apply the control test, and we have therefore asked HMRC to confirm in their guidance that any market standard documentation entered into in relation to the third party debt, such as a facilities agreement or inter-creditor agreement, will not be deemed to affect the PE House's rights for the purposes of the connection test.

But what about if the third party lender does have some equity, or an "equity kicker"? This is a difficult area and the answer as to whether the hybrid rules apply will be highly fact dependent. A solution, which we have suggested to HMRC on policy grounds, would be to exclude all third party debt from the application of the rules except where the arrangements amount to a structured arrangement (as described above). This could be achieved by introducing a legislative "normal commercial loans" exclusion and would be much the better approach than bringing third party loans in by way of the control group test and then excluding them under HMRC guidance.

Structures that have "checked the box"

Another area of the rules that is causing some difficulty for private equity structures is the situation where each of the entities in the UK acquisition stack (but not the underlying portfolio group) has checked the box to be treated as disregarded for US tax purposes. This is likely to be at the request of a US investor(s) in the fund.

This fact pattern could cause interest paid by Bidco on third party debt (where that debt is used to fund Bidco's acquisition of the portfolio group) to be counteracted under chapter 9.

Under chapter 9, if it is reasonable to suppose that Bidco and the US investor will both be able to claim a deduction for the payment of interest by Bidco (and if the other conditions are satisfied) then the deduction for Bidco is counteracted unless the deduction is against "dual inclusion income".

If Bidco has on-lent the bank debt to the portfolio group and uses the interest deduction to reduce the income it receives from that on-lending, it is likely that this would constitute a deduction against "dual inclusion income", because the US investor, having disregarded the structure down to and including Bidco, would also treat the amount received by Bidco from the on-lending as its income.

However, if (as is often the case) Bidco has used the third party debt to finance its acquisition of the portfolio group, then it may have limited income against which to set the deduction. Instead, Bidco might look to group relieve the interest deduction to the portfolio group. In this case the deduction is not against dual inclusion income, because the portfolio group is opaque for US tax purposes; the US investor does not recognise the portfolio group's income (against which the deduction is set) as its own. In this situation the rules may apply to deny the deduction at the Bidco level and thereby prevent the deduction being utilised at the portfolio group level.

Hybrid Payees subject to 0% tax

As with other chapters, chapter 7 (hybrid payee mismatches) begins by asking whether there is a mismatch i.e. whether a deductible payment made to a hybrid payee is greater than the sum of ordinary income brought into account by the recipients of that payment.

Consider an example: a deductible payment of £1m is made to an English limited partnership that has checked the box to be treated as a corporate for US tax purposes. None of the investors in the partnership recognise ordinary income as a result of the payment. Some (10%) do not recognise ordinary income by reason of the hybridity of the partnership. The other 90% (a mixture of US and UK pension schemes) do not because they are tax-exempt investors.

Where there is a mismatch chapter 7 (like other chapters) asks whether part or all of the mismatch arises by reason of the payee being a hybrid entity. In our example the mismatch is the full £1m, but only 10% (£100k) arises by reason of the hybridity of the payee. We would expect at this point that £100k of the deduction is therefore disallowed.

However, unlike other chapters, chapter 7 can deem further amounts of the remaining mismatch (£900k in our example) to arise by reason of the hybridity of the payee where "there is no territory where that payee is resident for the purpose of a tax charged at a rate higher than nil, under the law of that territory".

At first glance this provision causes the entirety of the remaining £900k in our example to be deemed to arise by reason of the hybridity of the partnership (and therefore disallowed) because a partnership is not tax resident anywhere.

This was causing real headaches for BVCA members, and the BVCA made representations to HMRC. In response a new provision, 259GB(4A), has been enacted in Finance Act 2018 which goes some way to addressing the concern. In our example, the effect of the new provision is that the £900k would only be disallowed if it is allocated to partners in jurisdictions that also view the partnership as opaque. This would mean that amounts allocated to US pension schemes would still be deemed to arise by reason of the hybridity of the partnership and disallowed, but amounts allocated to the UK pension schemes would not be.

What if the payment is made to a company in a 0% tax jurisdiction rather than to a partnership? Finance Act 2018 made another amendment to the deeming provision which is shown in underlined text above (the insertion of the words "at a rate higher than nil"). This amendment is significant. Previously a payment to a hybrid entity tax resident in a jurisdiction with a 0% tax rate would not have been subject to this deeming rule because it would still have been tax resident in a jurisdiction for the purposes of a tax charged under the law of that territory. The amendment makes it much more likely that it will be subject to the deeming rule, which could cause payments to such an entity to be counteracted where previously they were not.

Importantly, the new provision in 259GB(4A) only applies to hybrid payees that are partnerships and so would not dampen the impact of the deeming rule in this situation. We have written to HMRC to ask them to extend the provision to all payees.

Finally, it is worth remembering that this change does not just affect direct payments from the UK to a company in a 0% tax jurisdiction; it also affects situations where such a mismatch could be "imported" into the UK under chapter 11 (Imported mismatches).

State taxes and withholding taxes

The updated guidance (November version) makes it clear HMRC's view that US State taxes are not foreign tax that correspond to the UK income tax or charge to corporation tax on income within Part 6A. Nor are withholding taxes or, sales or turnover taxes. It is worth keeping this in mind when considering whether or not a payee recognised ordinary income.

Conclusion

A point we have not dwelt on above is that the rules do still go further than the OECD BEPS action they were introduced to address. The BEPS action is concerned only with situations where mismatches derive from hybridity – the UK rules openly acknowledge that they go further than this (take for example the deeming rule in Chapter 7 described above where the entirety of a payment to a hybrid entity in a 0% tax jurisdiction can be disallowed even if the mismatch has nothing to do with the hybridity of that entity). It seems that this principle is here to stay, and time will tell whether it makes the UK less competitive as against countries that implement the OECD rules only as they were intended.

That said, HMRC's view is becoming clearer and certain amendments to the guidance are helpful in giving taxpayers more of a steer as to their obligations. A good example of this is the statement that tax payers are not required to make disproportionate enquires when collating information in order to file their tax returns.

Market practice is also evolving in certain areas of the rules, for instance advisers are generally getting comfortable that the rules should not apply to situations where a third party lender with no equity stake makes a loan to a portfolio group. This consensus is assisted by updated guidance published by HMRC in November 2017 which clarifies the application of the rules in this area.

However in other areas (e.g. the same lender taking a minority equity stake in the portfolio group) uncertainty still reigns, and the rules will need to be considered carefully on a case-by-case basis.

05.

Corporate Governance Reform

Victoria Sigeti, Freshfields Bruckhaus Deringer

05. Corporate Governance Reform

Victoria Sigeti
Freshfields Bruckhaus Deringer

In the May and November 2017 Technical Bulletins, we discussed UK corporate governance reform and, in particular, the BVCA's engagement in the consultation process in relation to some of the changes likely to affect private companies. This article provides an update on developments in this area since November 2017.

BEIS Response to the Green Paper

In August 2017 the UK Department for Business, Energy and Industrial Strategy ("BEIS") published its response to the Green Paper on corporate governance reform. That response set out a package of measures, some of which were intended to be applicable to large privately held businesses as well as public companies.

Two key areas of focus for BEIS were:

- the establishment of a group to develop a voluntary set of corporate governance principles for large private companies and a requirement for all companies of a significant size to report on their corporate governance arrangements in their directors' reports and on their websites, including as to whether they adhere to any formal code; and
- the introduction of secondary legislation to require large private 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.

Corporate governance principles

A group was convened in November 2017 to develop the corporate governance principles for large private companies. The group, known as the "coalition", chaired by James Wates CBE (chair of the Wates Group), initially comprised the BVCA, the FRC, the Institute of Directors, the CBI and the Institute for Family Businesses. Since then, a number of additional organisations have been added to the group.

The BVCA has been, and intends to continue to be, actively involved in the coalition. One of the areas of focus has been reaching a consensus on what the key elements of good corporate governance are and how these will feed into the principles. An initial draft set of principles is now in circulation amongst the coalition and a series of stakeholder roundtables were scheduled in May 2018 (including with the BVCA) to provide feedback.

To support the development of the principles, senior stakeholders with recent and relevant experience in large privately owned companies are being appointed to an Executive Sounding Board to provide practical insight and advice. The BVCA has been involved in nominating senior stakeholders to join this body.

Whilst the application of the principles will be voluntary (in part, to enable companies to continue to use other industry-developed codes and guidance), all 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 any formal code. For large private companies, it is expected that where they do not follow any other corporate governance code, they will report using the principles as a basis. The BVCA is inputting into a draft of the secondary legislation to give effect to this requirement, which is currently intended to apply to companies which have either: (i) more than 2000 employees; or (ii) both a turnover in excess of £200m and a balance sheet in excess of £2bn. Certain additional details, such as how this will be applied to corporate groups, remain under discussion.

The intention is that a consultation paper on the principles will be released for public comment in the summer, with a final set of principles released by the end of 2018.

FRC Corporate Governance Code

In December 2017, the FRC published a consultation on proposed revisions to the UK Corporate Governance Code (the "Code") and the UK Stewardship Code.

Whilst the Code is aimed at publicly listed companies, the BVCA considered it appropriate to comment on certain of the proposed revisions given the influence the Code may have on corporate governance reform in relation to private companies and, in particular, on the corporate governance principles referred to above. Certain of the proposed revisions would also have a material impact on private equity backed companies approaching an IPO and the BVCA also considered it appropriate to comment on these.

Whilst certain BVCA members may be signed up to the UK Stewardship Code, the BVCA felt that there were other bodies better placed to comment on those aspects of the consultation so did not address them in its submission[4].

The overriding point made by the BVCA is that the private companies in which its members invest tend to share certain characteristics. Namely, that they are controlled by one or more private equity / venture capital funds (which in turn are managed or advised by regulated entities) and that they have a limited number of other shareholders who are, or have been, actively involved in the business. As such, these companies are typically well equipped to design and implement appropriate corporate governance frameworks and that it is therefore very important that corporate governance reform does not simply turn governance into a formulaic "one-size fits all" type of exercise and that any standardisation of governance practices does not dilute existing practices in this area or discourage innovation.

Section 172 reporting

The BEIS response to the Green Paper confirmed that the Government intends to introduce secondary legislation to require large private 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 envisaged that this reporting would 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.

The BVCA is inputting into a draft of the secondary legislation to give effect to this requirement, which has three principal elements:

- a requirement that all companies which are required to produce a Strategic Report include a statement explaining how the directors have complied with their section 172 duties;
- a requirement that companies with in excess of 250 UK employees (rather than the 1000 which was initially proposed) report in the Directors' Report on directors' engagement with and the regard they have had to employees; and
- a requirement that all companies which are required to produce a Strategic Report, also report on the regard they have had to suppliers, customers and others with whom the company has a business relationship.

[4] BVCA Response to Proposed Revisions to the UK Corporate Governance Code – available here

The FRC expects to produce guidance on the application of the new legal requirements in respect of the Strategic Report as part of revised Strategic Report guidance (which is intended to be the subject of further consultation).

The current intention is that the new requirements will apply to companies providing a Strategic Report and Directors' Report for financial years starting on or after 1 January 2019.

Next steps

The BVCA will continue to engage with relevant stakeholders in respect of all aspects of UK corporate governance reform to seek to ensure this continues to develop in a manner which adds value and does not impose a disproportionate burden on privately held businesses.

06.

Case Law Update

Thomas Laverty, Kirkland & Ellis

06. Case Law Update

Thomas Laverty
Kirkland & Ellis

Cross-border mergers: proposed date of merger in merger by absorption (High Court)

In *Re GET Business Services Limited [2017] EWHC 2677 (Ch)*, the High Court found that specifying a past date in the draft terms of merger as the date of entitlement of shareholders in the transferee company to participate in profits, is permitted under the Companies (Cross-Border Mergers) Regulations 2007 (SI 2007/2974) (as amended).

High Court holds notice of a warranty claim under SPA was not validly served

The High Court found in *Zayo Group International Ltd v Ainger and others [2017] EWHC 2542 (Comm)* that a notice of a warranty claim sent by the buyer under a share purchase agreement (the "SPA") was not validly served.

The notice clause of the SPA permitted delivery by hand (including by courier) to the address stated in the SPA "or such other address ... as may be notified in writing". Deemed receipt would then occur on delivery. A courier attempting to deliver the notice to one management seller was told that the management seller no longer lived at the address. The courier then left without leaving the notice. The court held that notice was not validly served, even though service by courier could have been achieved by leaving the notice at the address (including by leaving it with a person at that address).

The court also found that the option to notify a change of address was permissive only and that if a party chose not to notify a change of address, they would bear the risk that a valid notice may be delayed in coming to their attention and this would not affect the validity of the notice had it been left at the original address.

Contract required opportunity to remedy breach before termination (TCC)

In *Interserve Construction Ltd v Hitachi Zosen Inova AG [2017] EWHC 2633 (TCC)*, the Technology and Construction Court found that a defaulting contractor had the right to remedy its breach before the purchaser could terminate its employment. The underlying contract stated that the purchaser:"...may (at its absolute discretion) notify the Contractor of the default and if the Contractor fails to commence and diligently pursue the rectification of the default within a period of seven (7) Days... terminate the employment of the Contractor under the Contract."

The purchaser purported to terminate the contract immediately, stating that it was exercising its discretion not to allow seven days for rectification. However, the court held that no such discretion existed as the seven-day period was a condition precedent to termination for grounds to which the clause applied.

Twofold test for jurisdiction issues based on good arguable case and relative plausibility (Commercial Court)

In *Kaefer Aislamientos SA de CV v AMS Drilling Mexico SA de CV and others [2017] EWHC 2598 (Comm)*, the court considered: (i) the relevant burden and standard of proof that apply when determining a jurisdictional challenge under the Recast Brussels Regulation; and (ii) if the defendants were bound by a jurisdiction agreement as undisclosed principals.

The court concluded that to determine a jurisdictional challenge, the standard of proof had a twofold element rather than a unitary status. This means that the claimant is required to demonstrate: (i) a good arguable case; and (ii) in addition, that it had the better of the argument. The court also held that proof of one element could not in itself demonstrate the other.

Can a Court refuse to grant an order sought by the Panel on Takeovers and Mergers (the "Panel") under section 995 of the Companies Act 2006 (the "Act")?

Section 995 of the Act gives the Panel the power to apply to the court (the High Court in England and Wales and the Court of Session in Scotland) to secure compliance with rule-based requirements or disclosure requirements of the Takeover Code. Where the court is satisfied that a person has contravened a rule-based requirement or disclosure requirement, the court can make any order it thinks fit to secure compliance with the relevant requirement.

In this case, the Takeover Appeal Board (the "TAB"), which is the Panel's appellate body, refused an appeal by David King against a ruling that he be put under an obligation to make an offer to acquire the shares of other shareholders in Rangers International Football Club Pic (the "Rangers") on the terms stipulated by Rules 9.3 and 9.5 of the Takeover Code on the basis that he acted in concert with three other individuals in the acquisition of shares in Rangers.

The TAB ruled that Mr. King ought to make a Rule 9 offer to all Rangers shareholders within 30 days of its decision. Mr. King did not comply with the TAB's order and, as a result, the Panel initiated proceedings under section 995 of the Act to seek an order requiring compliance with the TAB's order by Mr. King.

The Outer House of the Court of Session in *Panel v King [2017] CSOH 156:*

- determined that courts have discretion to refuse an order sought by the Panel pursuant to section 995 of the Act; and
- granted the order sought by the Panel requiring Mr. King to make a Rule 9 offer to all shareholders of Rangers International Football Club Pic.

This case is significant as it is the first time that the Panel has used its powers under section 995 of the Act to enforce its requirements via the courts. Section 995 of the Act provides the Panel with a very effective enforcement tool backed by sanctions for contempt of court in case of non-compliance.

Arranger liable for invalidly executed transaction documents

A number of distressed debt funds run by the Fortress Group and Cyrus Partners Limited (the "Funds") started a judicial action against BNP Paribas, the arranger of a US$650m Islamic-law governed Sukuk (the "Sukuk"). The Sukuk defaulted following a number of allegations of fraud against the ultimate Saudi borrower under the Sukuk.

Following the default, the Funds were unable to enforce the promissory note before the Saudi Courts as it had not been executed in a way that was compliant with Sharia or Saudi law.

The court in *Golden Belt 1 Sukuk Company v BNP Paribas and others [2017] EWHC 3182 (Comm)* held that the arranger of a an Islamic-law governed Sukuk (the "Sukuk") had a duty of care to the holders of the Sukuk notes to exercise reasonable care to ensure the transaction documents were executed properly and that it had "dropped the ball" in making arrangements for the execution of that key document.

Specifically, the court held that:

- the arranger owed a duty of care to the Funds to ensure that the Sukuk notes were executed;
- the standard of care needed is that of a competent banker specialising in transactions of this nature;
- there was no need for the Funds to prove that they relied on the arranger as there is a market expectation that an arranger would ensure documents were executed properly; and
- the Funds could recover damages equal to the difference between the recovery they would have made (if any) had the note been valid and the recovery (if any) that they will in fact make.

While this case dealt with a Sukuk, the same principle might apply to other ECM transactions.

Buyer's notice of warranty claim: validity requirements

The case of *Teoco UK Ltd v Aircom Jersey 4 Ltd & Anor [2018] EWCA Civ 23* (18 January 2018) emphasises the importance of taking care in preparing a notice of a warranty or indemnity claim under an SPA in order to ensure that it complies with the relevant requirements of the SPA under which it is served. In particular the case serves to highlight the need to ensure that such notices explicitly refer to the particular warranties or provisions of an SPA that a Buyer is seeking to rely on when making such a claim.

The case concerned certain limitations to tax warranties and indemnities contained in a schedule to an SPA which set out that, among other things, the Sellers under that SPA would not be liable for any claim under such tax warranties or indemnities unless the Buyer gave written notice "setting out reasonable details of the claim (including the grounds on which it was based)" no later than 31 July 2015. The Buyer's solicitors sent a letter to the Sellers in February 2015, which was stated to be a notification of claim in accordance with "Schedule 4 of the SPA of the existence of Claims, being either Warranty Claims or Tax Claims", but did not specifically identify the particular warranties and provisions of the tax indemnity on which the claims were based. A further notice was sent to the Seller in June 2015 which included a breakdown of the alleged tax liabilities, but again did not specifically identify the provisions of the SPA on which the claims were based. In August 2015, the Buyer issued proceedings against the Sellers claiming damages for breach of the tax warranties and for a claim under the tax indemnity, which the Sellers applied to strike out on the grounds that the Buyer had failed to give proper notice.

The Court of Appeal held (approving the judgment of the High Court) that the notices provided by the Buyer to the Seller had each failed to satisfy the requirements of the SPA, as they did not identify the particular warranties and provisions of the tax indemnity on which the claims were based. While it is not inconceivable that, exceptionally, this requirement may be achieved without mentioning a warranty or other provision, in this case, there was real scope for doubt about which SPA provisions the Buyer thought to be relevant to its claims.

Cross-border mergers: Easynet Global Services Limited

In *Easynet Global Services Limited* ("Easynet"), the Court of Appeal held that a proposed transaction to merge a number of UK companies and a Dutch company (which was dormant, had never traded and had no significant assets) into a UK transferee company qualified as a cross-border merger within the scope of the Cross-Border Mergers Regulations and Directive (the "Regulations and Directive").

Under an earlier application by Easynet to the High Court, the High Court had held that the proposed transaction was not of the kind that the Regulations and Directive intended to facilitate and considered that the only purpose of including the dormant Dutch company with insignificant operations in the proposed transaction was as a "device".

The Court of Appeal held that the proposed merger did in fact qualify as a cross-border merger falling within scope of the Regulations and Directive. The Court of Appeal considered the Regulations and Directive in the context of Article 49 of the Treaty of the Functioning of the European Union (the right of freedom of establishment). The Court of Appeal found that there was nothing in the Regulations or the Directive to suggest that it was intended to allow any restriction on the right of freedom of establishment and that there would be a material restriction on the right of freedom of establishment if the UK's regime made it more difficult to proceed with a cross-border merger where it was proposed to include a foreign subsidiary of a UK company in another member state which was dormant or which had operations that were insignificant. On the basis of this assessment, and as the UK companies intended to establish themselves in a new corporate entity which would absorb the Dutch company, the court's view was that there was sufficient cross-border element to engage the Regulations and Directive for the proposed transaction.

No implied term allowing disclosure of confidential contract to potential buyer

The Court of Appeal in *Kason Kek-Gardner Limited [2017] EWCA Civ 2132* has rejected one party's attempt to imply a term into a contract, permitting disclosure of that contract to a potential purchaser, in breach of an express confidentiality clause contained in it.

Following administration, Company X sold certain business assets to two companies ("PCL" and "KKG" respectively). PCL subsequently gave KKG the right to use certain IP that it had acquired under the administration, pursuant to a licence agreement (the "Agreement"). The Agreement contained a confidentiality clause, breach of which resulted in a termination right for the non-breaching party.

KKG was subsequently acquired by a competitor of PCL (the "Buyer"), and the Agreement was disclosed to the Buyer as part of the sale negotiations. In response to this, PCL sought to terminate the Agreement. KKG argued that there was no breach of the confidentiality obligation, as it was subject to an implied term permitting KKG to "disclose the Agreement where reasonable for necessary business purposes", which included disclosure to a potential purchaser.

The Court disagreed, and held that for such a term to be implied, it must either (i) be necessary to give the contract business efficacy; or (ii) be so obvious as to "go without saying". As to limb (i), the Court held that the business purpose of the Agreement was to enable KKG to operate its parts of the business. A share sale may have been a "wider business purpose" of KKG's shareholders, but it was not strictly necessary for the Agreement to "work". As to limb (ii), the Court maintained that it was not "obvious" that PCL would have permitted KKG to breach the confidentiality obligations, especially in favour of a competitor (at least not without carefully negotiating the terms of that disclosure). The Court therefore upheld PCL's right to terminate the Agreement.

This decision is a useful reminder that there is no "blanket exemption" to complying with confidentiality clauses during the due diligence phase of a transaction. When acting for a prospective seller, judgement should be exercised in deciding whether to disclose confidential information to potential buyers (particularly in an auction situation). This involves evaluating the extent of the risk and commercial implications of disclosure. For example: (i) does breach of the confidentiality obligations result in a termination right for the non-disclosing counterparty?; (ii) if yes, would termination of that agreement jeopardise the sale itself (due to its having a material impact on the target's operations or price)?; and (iii) is the confidential information being disclosed to competitors of the target? If it is, increased caution should be exercised, due to the obvious risk that the competitor may use the disclosed information to gain a competitive advantage over the target.

If, (having weighed up the risks of disclosure as against the potential merits of the sale opportunity), it is decided that disclosure is still an attractive option, one possible solution could be to approach the counterparties to the confidential agreement for consent to disclose (assuming that this does not breach any market abuse provisions, if applicable).

Compulsory acquisition of minority shareholding

The *Privy Council in Staray Capital Ltd v Cha [2017] UKPC 43* confirmed the validity of amending a company's constitution in order to introduce a compulsory share redemption mechanism (the "Mechanism") which facilitated a minority shareholder being forced out of the company.

X (an 80% shareholder) and Y (a 20% shareholder) agreed to participate together in a project, with the Company being the project vehicle. However, the relationship between them broke down when X claimed that Y had misrepresented himself (and his qualifications), prior to the collaboration. X passed a special resolution introducing the Mechanism into the Company's constitution, permitting the Company to redeem a shareholder's shares, if it was shown that the shareholder had made a material misrepresentation in the course of acquiring the shares. The Company then served notice to compulsorily redeem Y's shares, and remove him as a shareholder.

Y challenged the amendment to the Company's constitution, claiming that it had been motivated by a desire to remove Y, and not a desire to act in the best interests of the Company. X accepted the first assertion, but maintained that an intention to remove Y was not inconsistent with the amendment being made in good faith.

The Privy Council upheld the amendment to the constitution, but found Y's misrepresentations to be immaterial (meaning that the Mechanism could not be used to force him out). In other words, the introduction of the Mechanism itself was valid, but the operation of the Mechanism in the present circumstances, was not. In reaching this decision, the Court made reference to the principles in *Re Charterhouse Capital Ltd [2015] EWCA Civ 536*, which stated that:

- a power to amend will be validly exercised if it is exercised in good faith in the interests of the company;
- it is for the shareholders, not the court, to say whether an amendment is for the benefit of a company, but it will not be for the benefit of the company if no reasonable person would consider it to be such; and
- the mere fact that the amendment adversely affects, and even if it is intended adversely to affect, one or more minority shareholders and benefit others does not, of itself, invalidate the amendment if the amendment is made in good faith in the interests of the company.

This decision suggests that, so long as an intention to act in the best interests of the company can be demonstrated, it is possible to amend a company's articles of association by introducing a compulsory acquisition mechanism, even if the principal motivation for doing so is to use that mechanism against an existing shareholder (or class of shareholder). This could potentially extend to the introduction of a drag-along provision (to apply where there is an offer by a third party), or, as in the present case, to a mechanism which effectively permits a minority shareholder to be "squeezed out".

Duty to disqualify unfit directors of insolvent companies

It was considered, in the case of The Secretary of State for *BIS v Akbar & Ors [2017] EWHC 2856*, whether the conduct of four separate directors was sufficient to make them "unfit" to be concerned in the management of the company (under section 6 of the Company Directors Disqualification Act 1986 (the "CDDA")). More specifically, the Court was asked to consider whether the CDDA should apply in the same way to two non-executive directors (who were the wives of the two executive directors, and were largely disengaged from the day-to-day running of the company).

The Court concluded that all four directors should face disqualification orders of varying lengths. With regards the two non-executives, the judge made clear that a lack of involvement in the business of a company is not sufficient justification for a breach of directors' duties. The suggestion that these two directors should escape disqualification on the grounds that they asserted little to no influence over the company was rejected, and this was reinforced with the citation of the following supporting dictum, from a previous case: "Staying as a director to do nothing (other than draw fees and preserve status) would not be a circumstance in which an unfit finding might be avoided."

This judgment is a stark reminder that directors of a company, once appointed, have an obligation to comply with the statutory duties inherent in this role, irrespective of their involvement (or lack thereof) in the running of that company.

Shareholder knowledge not to be imputed to the company

In *Julien v Evolving Tecknologies and Enterprise Development Co Ltd [2018] UKPC 2*, it was considered whether the knowledge of a company's sole shareholder ("S") could be attributed to the company itself. The question was asked in the context of determining whether the company's cause of action against its former directors (for their decision to make an inappropriate investment) was time barred under a statutory limitation provision. The former directors attempted to argue that, because S had known about the investment (and the associated risk) at the point that it was made, the company should be regarded as having been aware of the facts giving rise to the claim, from the time of the investment itself.

The Privy Council rejected this argument, and stressed the following fundamental distinction between directors and shareholders: a director's knowledge is typically attributed to the company because a director owes a duty to inform themself about the company's affairs, and report this knowledge back to the company (as appropriate). In contrast, shareholders owe no such duties to the company at all, meaning that there is no legitimate basis on which the rule of attribution can apply.

Furthermore, from a practical point of view, it would be impossible to attribute the collective knowledge of multiple shareholders to the company (but equally, applying such a rule to sole shareholders only appears arbitrary).

This decision is a useful reminder not to confuse the knowledge of a company's shareholders with the knowledge of that company itself, a distinction which could be of great practical importance when drafting an awareness qualification to a set of warranties, for example. More broadly, this case provides an insight into the factors which the courts may take into account, when considering whether the principle of attribution applies.

The right to inspect a company's financial records

In *Global Gaming Ventures (Group) Ltd v Global Gaming Ventures (Holdings) Ltd [2018] EWCA Civ 68*, the Court of Appeal was asked to consider whether a director (and majority shareholder) ("A") of a group holding company (the "Company") was entitled to inspect accounting records relating to a subsidiary of the Company (the "Subsidiary").

The Company had entered into a financing arrangement with a third party lender, who took charges over shares in the Subsidiary. The lender subsequently sought to sell these shares (via receivers) when the Company defaulted on its repayments. In order to monitor this, A requested access to certain financial information relating to the Subsidiary, both (i) in his capacity as a director of the Company; and (ii) under the terms of a shareholders' agreement relating to the Company.

The minority shareholder of the Company challenged this request, claiming that A was seeking the information for an "improper purpose" i.e., to challenge the receivers' actions, with a view to bringing future litigation proceedings. Under English common law, a director of a company is only authorised to inspect the company's financial records, if this is in furtherance of his or her duties to the company (and not for his or her own personal benefit).

The Court of Appeal disagreed with the minority shareholder however, and asserted that:

- a director's request to maintain oversight of a group company sale, particularly in a potential insolvency scenario, was a "proper purpose"; and
- even if it were not, any request to access financial records pursuant to a contractual right under a shareholders' agreement was not subject to a "proper purpose" test at all (as this was only applicable in the context of a director's request).

This decision suggests that, where a director is also a shareholder, it may be possible to circumvent the "proper purpose" test completely, by requesting access to the information under the authority of the shareholders' agreement (assuming that there is one, and that the relevant right under this agreement is unqualified). This should be borne in mind when drafting such agreements: if a company wants to ensure that shareholders are subject to the same restrictions as directors when requesting access to financial records, a "proper purpose" test (or something else bespoke) will need to be expressly included within the shareholders' agreement.

The obligation to pay up subscriber shares in cash

In *Zavarco plc v Nasir [2017] EWHC 2877 (Ch)*, a shareholder ("X") took subscriber shares in Zavarco plc ("Company A"), and in doing so signed A's memorandum of association (which required subscribers to take "at least one share" in Company A). In actual fact, X subscribed for some 360 million shares in A (the "Shares"). X did not pay for the Shares in cash, but subsequently transferred shares in Company B to Company A (the "Transfer"), and asserted that the par value of the Shares had been satisfied by this Transfer. This was challenged by Company A, and the High Court was called upon to consider (i) whether any such arrangement had been agreed between X and Company A; and more importantly (ii) if it had been, whether such an arrangement would have been valid.

The High Court held that:

- on the facts of the case, X had subscribed for the Shares on the terms of A's constitution, and not on the terms of any separate arrangement (either express or implied); and
- section 584 Companies Act 2006 (the "Act") (which requires that subscriber shares in a public company, that are taken in pursuance of the memorandum of association, must be paid up in cash (as defined in section 583(3) of the Act)) applied to all of the Shares (despite the memorandum only requiring subscribers take "at least one share").

Although this judgment is, to a certain extent, a product of its facts, it nonetheless provides some useful interpretive guidance on section 584 of the Act, namely that all shares taken by a subscriber in a public company (pursuant to the company's memorandum) must be paid up in cash (as defined). If a subscriber intends to pay up his or her subscriber shares other than in cash, it is important to make clear that they are taking those shares pursuant to a separate express agreement, and not pursuant to the company's constitution.

The courts' approach to the doctrine of frustration

In *The Flying Music Company Limited v Theatre Entertainment SA and others [2017] EWHC 3192 (QB)*, the High Court was asked to consider the doctrine of frustration, and whether it applied so as to relieve a contracting party ("Z") of its obligations under a contract (the "Contract"), to secure theatre venues for certain musical productions, as a result of civil unrest in the venue country.

The Court found that the Contract had not been frustrated, largely because at the point that the Contract was signed, there had already been significant disruption in the region. Z had therefore entered into the Contract with the knowledge that the existing political climate could continue post-signing, and was happy to contract on that basis. Even if Z had expected the situation to improve (as was argued), the Court were firmly unwilling to equate this unmet expectation with frustration: "If a bad situation becomes protracted, the consequences may be increased by the passage of time. But that does not mean that there has been a frustrating event. There has, in fact, been no change, and it is the lack of change which increases the consequences of an existing state of affairs. Even if the prolongation of trouble was unexpected… it was clearly a possibility, and it was for the parties to make their bargain accordingly."

With Brexit on the horizon, this decision serves as a timely reminder of the courts' reluctance to invoke the doctrine of frustration, in order to allow parties to escape their commercial agreements. If the risk of the "frustrating event" already exists at the point that the contract is signed (as in the above case, and, arguably, as in the case of Brexit), the courts will consider that all parties entered into that agreement with their eyes open, and will refuse to rescue them from that risk if it subsequently comes to fruition. An alternative approach may be to include an express force majeure clause instead (although obviously, any such clause would be subject to negotiation between the parties, and so may not be commercially viable).

An exception to the limitation period under the Limitation Act 1980

In *Burnden Holdings (UK) Ltd v Fielding [2018] UKSC 14*, the Supreme Court was asked to consider the possible application of section 21 (1)(b) of the Limitation Act 1980 (the "Act") to the following situation:

- Mr and Mrs X (the "Defendants") were the directors and controlling shareholders of Company A.

- The Defendants arranged for the shares held by Company A in a subsidiary company (the "Shares") to be transferred to a new holding company ("HoldCo"), in which they were the majority shareholders (the "Dividend").
- Some seven years later, the liquidators of Company A brought a claim against the Defendants for breach of fiduciary duty, arguing that the Dividend had been an unlawful distribution.

The Defendants argued that the six-year period in which to bring a claim (under section 21(3) of the Act) had passed, and the Supreme Court was called upon to consider whether section 21 (1)(b) operated to deprive the Defendants of this limitation defence. As a reminder, section 21 (1)(b) provides that the statutory time-bar on claims will not apply where the action is to recover trust property or proceeds of that property "in the possession of, or previously received by the trustee and converted to his use" (it being established that directors are to be regarded as "trustees" for the purposes of the Act).

The Court ultimately concluded that section 21 (1)(b) did apply here, and reasoned that, although the Defendants never received the Shares themselves (i.e., they didn't obtain any proprietary interest in the Shares), they nonetheless stood to derive an "economic benefit" from the Dividend, by virtue of being the majority shareholders in HoldCo. Section 21 (1)(b) should not be allowed to facilitate trustees (including directors) in appropriating misapplied property for themselves, and as a such there was no time limit on bringing proceedings against the Defendants.

This decision provides some much needed clarity on the application of section 21 (1)(b) to company directors, which has long since been uncertain. Specifically, this judgment confirms that even if a director does not obtain any proprietary interest in the misapplied assets, it suffices for the purposes of section 21 (1)(b) that he or she stands to derive an "economic benefit" from said assets.

High Court rectifies SPA and disclosure letter so as to reflect parties' intention

In *Persimmon Homes Ltd v Hiller [2018] EWHC 221 (Ch)*, a dispute arose between two contracting parties, as to what exactly they had each understood the buyer (the "Buyer") to be acquiring, under the terms of an SPA (the "SPA"). The Buyer had understood that the Target Group (as defined in the SPA) encompassed a development site comprising six plots of land (the "Plots"), and that it would be acquiring all rights and interests in the Plots. In fact, the freehold title relating to two of the Plots (the "Freehold Plots") was held by another company controlled by the seller (the "Seller"), and consequently, did not form part of the assets of the Target Group. The dispute was brought before the High Court, which resolved that:

- When looked at in conjunction with the disclosure letter and data room documents, it was clear that the definition of Target Group within the SPA did not extend to the group entities which owned the Freehold Plots.
- However, the evidence presented by the Buyer clearly demonstrated that, throughout the pre-completion negotiations, both parties understood that all Plots were to be included in the sale. For this reason, the SPA should be rectified (the "Rectified SPA"), to reflect this common intention.

One major consequence of this rectification was that the Freehold Plots were now within scope of the warranties in the Rectified SPA, meaning that the Buyer could potentially instigate a claim against the Seller for breach of certain of these warranties (such as the "good and marketable title" warranty) (the "Relevant Warranties"), in relation to the Freehold Plots.

However, if the disclosure letter (as it was currently drafted) applied to the Rectified SPA, the general disclosure as to freehold ownership would constitute disclosure against the Relevant Warranties, and negate any potential warranty claim in respect of the Freehold Plots. In response to this, the Court concluded that the disclosure letter should also be rectified, so that the disclosures relating to freehold ownership did not apply to the Freehold Plots, thus allowing the Buyer to bring certain breach of warranty claims against the Seller.

This decision clearly demonstrates the Court's willingness to adopt a more pragmatic approach to the construction (and if necessary, rectification) of not only the main transaction document but also certain auxiliary documentation, in order to give effect to the parties' common intention (as clearly documented in the pre-contractual phase). This highlights the importance of using clear and concise drafting in all transaction documents, and ensuring that said documentation is fully aligned with the wider negotiation process. If it is not, contracting parties risk the interference of the Courts.

Breach of directors' duties in an insolvency context

In *Ball (PV Solar Solutions Ltd) v Hughes and another [2017] EWHC 3228 (Ch)*, the High Court was called upon to consider a potential breach of a director's s. 172 CA 2006 duty, as it applies in an insolvency context.

A company ("C") was set up by two directors (the "Directors"). Despite C experiencing financial difficulties, the Directors subsequently enrolled C in a tax mitigation scheme, into which they made three separate payments (the "Payments"). These Payments were set-off against the outstanding sums in the Directors' respective loan accounts, such that these loans were effectively cancelled out. When C subsequently went into administration, the liquidator brought claims against the Directors, alleging that:

- C was already insolvent when the Directors made the Payments, which was a breach of the Directors' duties under s. 172 CA 2006 (to act in the best interests of C's creditors, as per s. 172 (3) CA 2006); and
- the Payments were, in reality, a form of unauthorised remuneration. It was noted that neither Director had entered into a contract of employment with C, and instead the relevant articles of association required that all directors' remuneration be pre-approved by ordinary resolution (which never happened).

In analysing the s. 172 duty in respect of creditors, the Court gave express consideration to (i) when this duty is triggered; and (ii) whether the test is to be applied objectively or subjectively.

In relation to (i), the Court suggested that the duty was triggered where there was a real, as opposed to remote, risk of insolvency - a test which could sometimes require directors to consider matters that "will impact materially in the near future" (albeit noting a reluctance to widen this scope to risks that were not "reasonably proximate in time"). The Court held that this duty had been triggered in the present case. In relation to (ii), the Court explained that the s. 172 duty is ordinarily regarded as a subjective test, but that this is subject to a qualification in the case of insolvency (or dubious solvency): here, the duty extends to consideration of the creditors' interests, and their interests must be considered as "paramount". If the directors subjectively fail to have regard to these creditor interests, the Courts will carry out an objective application of the s.172 test. In the present case, the Directors had failed to consider the interests of C's creditors in making the Payments, and it therefore fell to Court to consider whether, objectively, "an intelligent and honest man in the position of a director of the company" could reasonably have believed that the Payments were for the benefit of the creditors as a whole. On the facts of the case, this objective test failed, and the Directors were found to be in breach of s. 172 CA 2006.

Regarding the unauthorised remuneration, the Directors accepted that the Payments had not been authorised by any express resolution of C, but argued that, as C's only shareholders, they could be taken to have approved of them by way of a unanimous informal resolution, in accordance with the Duomatic principle (the "Principle"). This argument was rejected on two grounds: (i) there was no evidence that, as required under the Principle, the Directors had directed their minds to the subject matter of the resolution; and (ii) in any event, the Principle does not apply where a company is insolvent.

This decision provides useful guidance on how the Court will interpret both the s. 172 duty and the Duomatic Principle in an insolvency situation.

Joint venture contract subject to implied duty of good faith

In *Al Nehayan v Kent [2018] EWHC 333 (Comm)*, two parties (A and B) entered into an oral agreement to invest in a new business venture. When the venture initially ran into financial difficulties, A injected additional capital into the business (at B's request), but declined to provide further funding when the business's prospects continued to worsen. A subsequently requested that his interests be separated from B. In doing so, B signed a promissory note in favour of A, under which he agreed to repay A's capital contributions in annual instalments. When B failed to make these payments, A sought to bring a claim against him. In response, B advanced a counterclaim against A, alleging that, as part of their joint venture, A had owed a duty of good faith to B, and, on the facts of the case, A had breached this duty.

The High Court ultimately agreed with B, and in doing so, expressed itself willing to imply a duty of good faith into an oral joint venture contract. In reaching this decision, the Court highlighted the fact that the contract between A and B was a "relational" one, i.e. a category of contract in which the parties "committed to collaborating with each other, typically on a long term basis, in ways which respect the spirit and objectives of their venture but which they have not tried to specify, and which it may be impossible to specify, exhaustively in a written contract". The Court went on to explain that, although the general position under English law remains that the Court will only imply a duty of good faith into a contract when to do so is necessary to give "business efficacy" to the agreement, the Court is much more likely to conclude that this test is satisfied in the case of a "relational" contract.

The Court expressed that it was not necessary (or possible) to set out an exhaustive list of what this duty of good faith entailed, but provided two examples of A's conduct which it deemed inconsistent with the implied duty: (i) entering into negotiations to sell his interest in the business to a third party, without informing B; and (ii) using his position as a shareholder of the business to obtain a financial benefit for himself, at the expense of B.

Whether a contract is classified as "relational" will need to be judged on a case-by-case basis, but certain agreements certainly seem to be strong candidates (e.g. franchise or distribution agreements, and of course, joint venture agreements, particularly if they are oral). Parties looking to enter into these sorts of contracts should be mindful of the Court's willingness to impose additional duties of good faith on them, where to do so is necessary for business efficacy. If parties wish to prevent the Courts from being able to do so, they need to ensure that their contract "works" without this implied duty (by detailing exactly what said duty equates to, within the context of that particular agreement).

Shareholders cannot claim for loss in the value of their company

In Breeze and another *v Chief Constable of Norfolk [2018] EWHC 485 (QB)*, the claimants (the "Claimants") were shareholders in a company ("C") that provided medical health services to the NHS. They had been arrested and charged with fraud but were subsequently acquitted some two years later. In the interim however, C went into receivership and was ultimately dissolved. The Claimants brought an action against the police for malicious prosecution, claiming that the police should have foreseen that the prolonged investigation would cause C's financial condition to deteriorate, and they sought to recover the loss in the value of their shares in C.

The police subsequently made a striking-out application, on the basis that the claim fell foul of the "no reflective loss" principle of English law (the "Principle"). By way of a reminder, the Principle states that the only person who can sue in respect of a wrong done to a company is the company. Although shareholders may suffer loss in respect of this same wrongdoing (if the value of the company's shares go down, for example) a shareholder is precluded from suing for these losses.

The Claimants counter-argued that the Principle is confined to the narrow circumstance where a company has the right to claim for a breach of duty owed to it. However, the High Court rejected this. Provided C could have sued (under any cause of action) for the loss of value in its shares, then the Principle applied so as to bar the Claimants for also suing for that loss. A claim founded in a breach of duty was not necessarily required.

This decision is a useful reminder of the no reflective loss principle- and quite possibly an extension of the Principle to claims beyond breaches of duty owed to a company (it is unclear whether there are any other authorities which apply the Principle absent any such breach, but the judgment doesn't cite any). Shareholders should be mindful of the Principle, and remember that, if the company suffers any recoverable loss as a result of a wrongdoer's action, the shareholder will be unable to claim for the loss that (s)/he suffers as a result of that loss, and will need to think of alternative heads under which to bring an action (such as a derivative claim, where available).

07.

National Security & Infrastructure Investment Review

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Introduction

The Government published a National Security and Infrastructure Review Green Paper in October 2017 in which it outlined its plans to review, and potentially block or unwind, investments on national security grounds. The proposals were split into two parts: short term proposals and long term proposals. The short term proposals include amending the thresholds of the existing public interest regime to catch a broader range investments in the military and dual use sector and the advanced technology sector. In the longer term, the Government is considering introducing broader powers to call in deals for national security screening and/or to require mandatory filing for foreign investment in certain key areas such as nuclear, defence, energy, transport and telecoms.

The consultation on the short term proposals closed in November 2017 and the Government published its response in March and passed two statutory instruments amending the Enterprise Act to implement its proposals on 14 May. The consultation on the longer term proposals closed on 9 January and the Government is yet to publish its response to this consultation.

The BVCA responded to both consultations on behalf of its members stating that it is generally supportive of measures to protect the UK's national interests, but that any new filing process should be voluntary, proposals should be clearly defined to give certainty and that there must be flexibility to obtain informal clear guidance from the authority enforcing any new regime to facilitate transparent and clear implementation. The BVCA (and other respondents to the consultation) raised concerns in its response about the potential for the definition of "dual use items" to bring a number of businesses into scope which manufacture or hold items which present no national security concerns.

National Security and the current UK merger regime

The key powers provided to the Government to intervene in mergers that may give rise to national security concerns are set out in the Enterprise Act 2002, which also establishes the UK's merger control regime. The merger regime is based on voluntary notifications, with the power for the Competition and Markets Authority ("CMA") to 'call-in' transactions which meet certain thresholds.

Under the current merger regime, ministers may intervene on national security grounds where the transaction meets the thresholds under the EU Merger Regulation or the UK merger regime and where that transaction raises a "public interest consideration" concern. The thresholds under the UK merger regime are met if: (i) the UK turnover of the business being acquired exceeds £70 million; or (ii) the transaction results in the creation of, or increase in, a 25% or more combined share of sales or purchases in (or in a substantial part of) the UK, of goods or services of a particular description.

If these thresholds are not met, ministers may only intervene if the transaction raises a defined public interest issue; for example, if one of the parties is a UK defence contractor. This power has not been used in practice.

New regime for sensitive sectors

The new secondary legislation reduces the thresholds applicable to transactions to bring them in scope of the "call in" regime. The new thresholds will apply only to deals involving targets active in any of the following sensitive sectors:

i. ownership, creation or supply of IP relating to the functional capability of computer processing units ("CPUs"), the instruction set architecture for such units or computer code that provides low level control for such units;
ii. design, maintenance or provision of support for the secure provisioning or management of "roots of trust" for CPUs and other code/instruction sets that provide low level control of CPUs;
iii. development or production of military/dual use items or holding of related information; and
iv. development or production of quantum technologies (computing, encryption, simulation, communication, imaging, sensing or navigation).

The reduced thresholds are met if: (i) the target has UK turnover (in any products or services, not just in the sensitive sectors) of more than £1 million; or (ii) the target has a share of supply of products or services in one of the affected sectors of 25% or more, irrespective of whether the buyer has any activities in that sector (no overlap required).

The new thresholds can be applied to call in any deal that completes after 11 June and therefore may apply to deals already executed that have not yet closed.

The Government has published guidance alongside the new provisions which explains in more detail how the sensitive sectors listed above are defined, the operation of the new thresholds and the process for any Government intervention in affected mergers.

The BVCA (and other respondents) raised concerns about the significant reduction of the current thresholds and the additional burden which will be placed on parties which would fall under the revised scope.

There will be no mandatory filing requirements for transactions which meet the new thresholds. If parties consider the merger is unlikely to raise any competition or public interest concerns they can choose not to notify the CMA and accept the risk that the CMA and/or the Government may take a different view. Transactions that are called in by the CMA will be assessed for their effect on competition grounds as well as their impact on national security. In principle, transactions meeting the new thresholds may be called in for review by the CMA solely on competition grounds, even if the Government has no national security concerns, but the CMA has indicated that it does not anticipate doing so.

Long term proposals

In the longer term, the Government is considering two options for the introduction of a more comprehensive regime for screening foreign investments, which may be implemented alone or in combination:

- an expanded version of the voluntary filing regime under the Enterprise Act 2002, to allow the Government to "call in" and scrutinise a broader range of transactions for national security concerns, including new projects and bare asset sales; and/or
- a mandatory notification regime for foreign investment into the provision of a focused set of 'essential functions' in key parts of the economy, for example the civil nuclear and defence sectors.

Expanded voluntary regime

Under this option, the Secretary of State would be able to make a special "national security intervention" in respect of a broader range of transactions than is currently possible, including the following:

- Acquisitions of “significant influence or control” over a UK business entity. Such acquisition could be by any investor, domestic or foreign. The Government is considering defining the test for significant influence or control as satisfied by the acquisition of either: (i) more than 25% of a company’s shares or votes; or (ii) less than 25%, but with other means of exercising such control. The scope of these “other means” would be clarified in Government guidance and would reflect issues specific to national security and national infrastructure, such as access to sensitive sites or data. The BVCA’s response to the consultation made clear that such test should be focussed on parties who have control or material influence over the activities in question, in line with the established test of “material influence” in the Enterprise Act (to avoid capturing passive investors for example);
- New projects, in particular, developments and other business activities that are not yet functioning businesses but can reasonably be expected to have future activities that may affect national security interests; and
- Sales of bare assets (i.e. assets such as machinery or intellectual property transferred without the other elements of a stand-alone business).

If a voluntary notification is not made, transactions which fall within this scope could be “called in” for review by the Secretary of State within a certain time period (envisaged to be three months) if it is believed the transaction raises any national security risks. A national security review would be a separate process to any competition review.

Mandatory filing regime

The Government paper also sets out the option of a mandatory filing requirement for acquisitions by foreign investors of significant influence or control (as described above) over businesses with certain “essential functions” in key sectors. Examples of sectors the Government is considering for inclusion in the mandatory screening regime include defence, energy, transport, civil nuclear and advanced technology. Mandatory notification could also be required for foreign investment in key new projects, certain real estate and/or specific businesses or assets. The Government is minded to exclude from mandatory notification (but not from scope generally) sectors such as chemicals, financial services, food, health, space and water from any mandatory filing regime on the basis that existing regulatory regimes will ensure they do not escape scrutiny.

The BVCA has responded to this consultation stating that:

- it does not consider a mandatory regime is necessary or proportionate – a voluntary regime would be preferable;
- any mandatory regime would need to apply to very clearly defined sectors and that uncertainty in a new regime would likely discourage investment in the UK;
- any call in period must be clearly defined and short so as to minimise business uncertainty;
- there should be flexibility to obtain informal prior guidance to facilitate transaction certainty; and
- imposing a mandatory notification regime would increase transaction costs, not just in obtaining clearance but in covering the cost of funding while waiting the outcome.

Next steps

Transactions that close on after 11 June 2018 will be subject to the new thresholds. The Government is currently considering responses to the consultation on the longer term reforms but has not set a date when it will issue its response.

08.

DWP White Paper on Protecting Defined Benefit Pension Schemes

Jonathan Wood, Weil Gotshal & Manges
Camilla Barry, Macfarlanes

08. Department for Work & Pensions (DWP) – White Paper on Protecting Defined Benefit Pension Schemes (the White Paper)

Jonathan Wood
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Overview

The White Paper sets out the Government's approach for the future of the Defined Benefit ("DB") pension scheme system in the UK. It aims to deliver on manifesto promises to strengthen the existing regime to enable the Pensions Regulator (the "Regulator") to be clearer, quicker, and tougher in its actions against employers who are not delivering on their legal obligations. While the Government believes the existing DB pensions system is working well for the majority of DB schemes, trustees, and employers, the White Paper notes that a more robust regime is required for those few cases in which irresponsible decisions can impact detrimentally on DB schemes.

Overall, the White Paper (prepared in a politicised, post-Carillion environment) adopts a more aggressive approach in respect of empowering the Regulator than the DWP's 2017 green paper on Security and Sustainability in DB Pension Schemes (the "Green Paper").

The White Paper focuses on improving existing powers and introducing new powers for the Regulator. There is also a general aim of facilitating more informed decisions by trustees in respect of scheme funding, enabling easier and earlier Regulator intervention, and creating conditions for schemes to consolidate so that the benefits of scale can be realised.

At a glance, the key changes introduced by the White Paper are:

- Criminal sanctions and fines for those guilty of the most egregious conduct vis-a-vis a DB pension scheme (albeit with uncertainty in the White Paper as to exactly what that conduct is).
- A requirement for companies to make a statement of intent requiring agreement in advance with the trustees/Regulator for material financial transactions that could impact the financial support for a DB scheme.
- The need for advance notification of certain transactions.
- A power for the Regulator to conduct interviews, including advisers, to get a complete picture on a particular DB pension scheme so as to target investigations.
- A requirement to target buy-out or near buy-out as a long-term funding objective.
- Delegated legislative authority for the Regulator on funding rules.
- The requirement to demonstrate compliance on funding in a chair's statement.

The result will be that those in the private equity and venture capital community who either own or plan to own businesses with DB pension schemes, particularly those with deficits, will have to tread even more carefully.

A stronger Regulator

A range of new powers are proposed to strengthen the regulatory framework and the Regulator, principally by developing stronger deterrents against wrongdoing through punitive fines, introducing criminal sanctions, and enhancing the existing voluntary clearance process.

Stronger deterrent through punitive fines

The Regulator will be granted powers to punish those whose detrimental activity puts pension schemes at risk, by introducing punitive fines to tackle irresponsible activities that may cause a material detriment and compromise the funding position of a scheme. Though the proposed penalty regime is still under development, the White Paper anticipates that the relevant fine would be linked to a contribution notice, effectively creating the possibility of a highly punitive fine being issued directly by the Regulator.

The feasibility of retrospectivity is also being examined in respect of the penalty regime, whereby it could apply to acts or omissions prior to enactment of the primary legislation that will bring it into force, i.e. from the date of the White Paper's publication (19 March 2018). It is, therefore, implied that, although there may be no new primary legislation within the next year or so, the new measures contemplated by the White Paper will empower the Regulator to penalise events and actions occurring now.

Criminal sanctions

A new criminal offence to punish proven wilful or grossly reckless behaviour of directors and connected persons in relation to DB schemes is proposed. Consultation will continue over the coming months to ensure these measures would be proportionate. Existing provisions for the disqualification of directors whose behaviours do not meet the expectations of the role will continue to apply, with a new focus on increased efficacy under that system.

Generally, certain key terms used throughout the White Paper and particularly in respect of the punitive proposals will require careful and clearer definition when transposed into policy or legislation, e.g. the relevant tests or thresholds for "grossly reckless" and "willful" and the nature of the "behaviours" that will be criminalised.

Building on the voluntary clearance process

The White Paper recognises that the existing notifiable events framework and voluntary clearance regime work well in most cases. It does not introduce a mandatory clearance regime, which had been mooted in the Green Paper, which is positive.

However, the proposals aim to build on these existing regimes to strengthen the clearance system so that employers give sufficient regard to their scheme during corporate transactions. It identifies areas where changes could be made to the notifiable events framework, in particular in respect of coverage and timing (the existing requirement to notify "as soon as reasonably practical" after the specified decision or event will be changed to ensure that the Regulator is made aware at an earlier stage and can engage in discussions earlier).

The White Paper states that the Regulator has an interest in events that are materially detrimental to the scheme's capacity to meet its liabilities, e.g. a restructuring or a sale that reduces the covenant strength supporting the scheme. Other examples provided that could be considered include a change in creditor priority to rank ahead of the scheme upon insolvency, a return in capital, and other mechanisms which result in value being extracted from the employer.

Given there are currently notification obligations on a share sale by an incorporated entity, the White Paper's contemplation of what might constitute a relevant transaction is implicitly wider than at present, and could cover a range of corporate actions, e.g. re-financings, distributions, intra-group arrangements, reorganisations, asset acquisitions and guarantees.

Therefore, while the proposal in the Green Paper to make Regulator clearance mandatory on all transactions has not been progressed, the series of new and restated obligations around “transactions” makes the necessity for clarifying that term as it applies to the Regulator in each respect especially important, which is not conclusively achieved in the White Paper. The effect may well be that clearance is now sought in almost the same way as it would be had a mandatory regime been introduced.

There is also a proposal to require employers or parent companies to make a “statement of intent” (in consultation with trustees and prior to the relevant business transaction occurring) that they have appropriately considered the impact on any DB scheme that may be affected, setting out how the employer intends to mitigate any detrimental impact and thus enabling trustees to better engage with the Regulator if the scheme is put at risk. In this context, the White Paper states that “relevant” business transactions will include only those which pose the highest potential risk to the scheme, such as the sale or takeover of the employer. However, this is still not defined definitively, and it is noted that the Government will work with the Regulator, business groups, and other stakeholders to determine the ultimate approach to the issue.

The requirement for a “statement of intent” to be agreed in advance of a transaction and in consultation with the trustees may have broadly the same effect as a mandatory clearance regime. The trustees may involve the Regulator and the regime will be backed up by the threat of criminal sanctions against “wilful” or “grossly reckless” directors who do not respond to address risks identified by the trustees or the Regulator.

Further measures to strengthen the Regulator

Other additional or extended powers are proposed in respect of the Regulator’s ability to gather information, require attendance for interview, inspect records, documents, and devices, and impose fixed and escalating penalty notices, as an alternative to criminal sanctions, for non-compliance with a section 72 notice without a reasonable excuse.

The power to compel an individual to interview to explain any facts, events, or circumstances relevant to the Regulator’s investigation or function is a significant broadening of existing interview requirement powers under section 72(1A) of the Pensions Act 2004, which is currently applicable only in respect of specific and narrow contexts. In practice, we consider that this enhanced power may produce particularly onerous and time-consuming effects, e.g. in respect of preparation and the need for legal counsel to attend such interviews. The Regulator however envisages that it will increase efficiency by avoiding the need for poorly directed document requests under section 72.

The Green Paper considered imposing a “duty to co-operate” on relevant employers in respect of the Regulator’s information-gathering processes, but this proposal has been dismissed for now, pending further consideration as part of wider discussions on emboldening a more proactive Regulator. Advisers would be given statutory protection to release them from confidentiality duties in relation to Regulator interviews. It appears however that communications with legal advisers will remain protected as under the present legislation.

Scheme funding

The Government will seek to strengthen the Regulator’s ability to enforce scheme-funding standards via a revised Funding Code of Practice which will become legally binding. The consultation will also address what further guidance trustees may require to ensure that they take a long-term view when setting the statutory funding objective and that they best assess their statutory funding objective’s robustness against external risks. The effect will be to reduce trustee discretion and make it easier for the Regulator to mount a challenge.

The Government also intends to require the trustees of DB schemes to appoint a Chair and for that Chair to report to the Regulator on key scheme funding decisions, along with their triennial valuation and to legislate to give the Regulator power to ensure compliance with this new requirement. The Chair's statement is intended to drive accountability and will be required to inform the Regulator about the trustees' approach to managing risk.

Scheme consolidation

The Government will seek to improve the existing system in respect of scheme consolidation (whereby administrative functions and/or assets and liabilities are pooled, and can therefore enable more effective investment strategies and reduced scheme costs per scheme member) by consulting in 2018 on: (a) proposals for a new legislative framework and authorisation regime within which new forms of consolidation vehicles could operate; and (b) a new accreditation regime that could help build confidence and encourage existing forms of consolidation.

The White Paper proposes the possibility of commercially run consolidation vehicles that, if designed properly, would represent a key development in the DB sector and could both reduce inefficiency in the system and have the potential to offer better long-term outcomes for scheme members.

The Government also intends to work with the Regulator to raise awareness of the benefits of consolidation with employers and trustees, and will consider other minor changes to support certain benefit simplification, which would help reduce complexities in certain existing benefit structures, but there is presently no suggestion that consolidation would be compelled for small, underperforming schemes.

Delivering the White Paper reforms

Some of the White Paper's proposals can be implemented quickly or are already underway, such as the Government working with the Regulator to increase awareness of consolidation options, supporting scheme members to understand the funding position of their scheme, and raising awareness of scheme funding measures.

However, the White Paper broadly acknowledges that the DB system is complex and most proposals in relation to it require considered thought to ensure that unintended consequences are not generated. The White Paper also acknowledges that further work is required before the Government proceeds to legislate in order to ensure effective, proportionate, and practical outcomes; during 2018 and 2019, the Government and the Regulator will carry out various consultative exercises on particular policies. The White Paper notes that, while it may be possible to progress some measures with secondary legislation, primary legislation will be needed in most cases – and this is unlikely to happen until the 2019-2020 parliamentary session at the earliest.

09.

PRIIPS update

Ed Kingsbury, Dechert

09. PRIIPS update

Ed Kingsbury
Dechert

"The concept of the KID is admirable; unfortunately its execution is a disaster"
John Kay, "Risk, the retail investor and disastrous new rules" Financial Times, 19 January 2018

Overview

The Packaged Retail and Insurance-based Investment Product ("PRIIP") regime applied from 1 January 2018 and imposes an obligation to produce and make available a Key Information Document (or "KID") if:

- a PRIIP – such as a private equity or venture capital main fund vehicle, venture capital trust, European Venture Capital Fund ("EuVECA"), or co-investment and carry vehicle (a PRIIP is defined widely as an investment where the amount payable is subject to fluctuations due to the performance of assets which are not directly purchased by the investor, irrespective of legal form);
- is made available – whether directly or indirectly, and regardless of whether a reverse solicitation occurs, whether or not an investor is advised, and whether or not the person making the PRIIP available is located in or outside the EEA; and
- to one or more retail investors in the EEA - under the MiFID II definition, which includes any high net worth or sophisticated investors, local authorities, and friends and family who cannot be opted-up.

It imposes obligations on manufacturers and distributors (such as fund managers, group sales and distribution entities, and placement agents), requiring that a manufacturer produces a KID and makes it available on its website and in hard copy free of charge, and that the KID is provided to retail investors in good time to consider it before they invest. No actionable guidance has been provided on what "in good time" means, other than it depends on the needs, experience and knowledge of the retail investor and the complexity of the fund.

A KID is a three page, standard-form, stand-alone document with detailed and prescriptive contents requirements that leave little discretion and can under certain circumstances produce surprising results.

Recap

Since the previous BVCA note on PRIIPs in November 2016, further guidance has been provided at both EU and FCA levels. The European Commission published regulatory technical standards in March 2017, the FCA Policy Statement PS17/6 was published in May 2017, and July 2017 saw both a Q&A from the European Supervisory Authorities and a communication from the European Commission with additional guidelines.

The intention of the PRIIPs regime was to harmonise divergent EU member states' disclosure obligations for complex retail products, simplify cross-border marketing and help retail investors to compare products and make more informed choices on the basis of short, comprehensible and comparable KIDs. However, since implementation, it has faced a barrage of complaints from asset management firms and industry bodies focused on the costs and performance disclosure methodology, prompting a response from Steven Maijoor, Chair of the European Securities and Markets Authority ("ESMA") in March that ESMA is "*ready and willing*" to look at the issue of flawed methodology but needed "concrete evidence to assess whether these flaws are real[5]".

[5] Steven Maijoor, speech to BVI 2018 Annual Reception, Brussels, 20 March 2018

In April, Andrew Bailey, Chief Executive of the FCA voiced concerns about PRIIPs; "*I want to be clear that I am concerned about PRIIPS …. It carries a risk that it is leading to literally accurate disclosure which is not providing useful context, and there is evidence that funds, for instance from the US, are withdrawing from Europe to avoid the burden. I have also heard concerns about performance projections. We all have to take this seriously*"[6].
Since implementation:

- The requirement to produce KIDs and the administrative burden of opting-up investors (see below) has dissuaded some fund managers from marketing to high net worth investors and other categories of investor where otherwise permitted under EEA national private placement regimes.
- Fund managers for whom high net worth investors are an important source of capital have produced KIDs, and having set up the systems and acquired the know-how to produce them have seen economies of scale for subsequent KIDs (to compensate for the initial cost in blood and treasure).
- EuVECA fund managers seeking to use the high net worth investor passport have tended to produce KIDs.
- The concentration of angel investors in Monaco and of high net worth investors in Switzerland (both outside the EEA, though subject to their own marketing regimes) has spared some fund managers the requirement to produce a KID.

Retail investors

A "retail investor" includes any person or entity that does not fall into one of the per-se professional client categories under MiFID II and is not an elective professional client that has been opted under MiFID II. Many firms with AIFMs will be aware of the opt-up test in relation to exercising the AIFMD marketing passport. The opt-up process requires that a prospective investor:

A. meets a qualitative and a quantitative test (see below);
B. states in writing that the investor wishes to be treated as a professional client;
C. receives a clear written warning of the protections and investor compensation rights it would lose on opt-up; and
D. states in writing in a separate document from the contract (for example, not in a subscription document) that the investor is aware of the consequences of losing those protections.

The qualitative test requires an adequate assessment of the expertise, experience and knowledge of the individual that gives reasonable assurance, in light of the nature of the transaction envisaged, that the individual is capable of making investment decisions and understanding the risks (in this case, of investing in the relevant fund).

The quantitative test requires an investor to meet two of the following:

1. in the previous four quarters, it has carried out ten equivalent transactions at an average frequency of 10 per quarter;
2. it holds investments, cash deposits and financial instruments worth over €500,000;
3. the investor works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged (i.e. investing in a fund).

[6] Andrew Bailey, London Business School Annual Asset Management Conference, 26 April 2018

Tests 2 and 3 are the most commonly used. Only the most voracious fund investors will have conducted 40 transactions in private equity or venture capital funds in a 12 month period, even including purchases and disposals. Helpfully, a reasonable proportion of angel and high net worth investors have worked in private equity, investment management or mergers and acquisitions.

UK Local Authority Pension Funds ("LAPFs")

UK LAPFs and the eight UK LAPF asset pools are retail investors by default, and under the FCA Rules are subject to a modified quantitative test:

1. the value of its financial instrument portfolio, cash deposits and financial instruments exceeds £10m; and
2. it meets one of the following:
    - a. the investor has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters; or
    - b. the person authorised to carry out the transaction on behalf of the investor works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the provision of services envisaged; or
    - c. the investor is an "administering authority" of the LAPF and is acting in that capacity.

Most LAPFs have prepared and can provide a due diligence pack with further information to assist the qualitative and quantitative tests. Fund managers with existing LAPF fund investors would have received packs from them in Q4 2017 to categorise them before MiFID II came into force on 3 January 2018

No consideration

The European Commission in July 2017 confirmed that a product whose acquisition does not require any payment or consideration from a retail investor (i.e. no initial payment or any risk of future financial commitments) is out of scope and so does not trigger the KID obligation.

Carry vehicles that do not require retail investor carry holders to contribute any capital would not require a KID. The absence of any formal "de minimis" threshold for consideration conflicts with the requirement in certain jurisdictions that a partner should contribute a nominal amount of capital.

Contents

The content obligations for a KID are precise and detailed, and require significant amount of data to be identified and subjected to a range of calculations. As a result, some private equity and venture capital firms have outsourced their production to third party KID service providers.

KIDs should be fair, clear and not misleading, and their contents should be reviewed regularly, kept up-to-date, and provided to any retail investor in the EEA to which the PRIIP is made available before they invest (in which case there is no obligation to provide an updated KID after they invest). In the context of a typical closed-ended fund with no withdrawal rights, it seems reasonable to conclude that the KID obligation would cease on final closing. The position is more nuanced for coinvest vehicles with later joiners or stapled secondary and to primary commitments.

The KID must be translated into the official language of each EEA member state in which the PRIIP is made available, or in another language accepted by the regulator of that state. Local practices vary; in Luxembourg, KIDs can be provided in English, in Germany, semi-professional investors may receive a KID in English but other retail investors must receive a KID in German.

Performance

Future expected performance must be estimated, calculated and presented in accordance with a prescribed method under four scenarios - favourable, moderate, unfavourable and stress. There are widely-held concerns that the performance scenarios and calculation methodology are overly optimistic, which conflicts with the obligation on firms to ensure that a KID's contents are fair, clear and not misleading.

As a result, the FCA in a statement on 24 January 2018 permitted firms to include (a) explanatory materials to set the calculations in context and (b) any concerns for investors to consider. Where there is a mismatch (for example, a "moderate" scenario would indicate outsize returns, or a "negative costs" result which suggests that the manager pays investors), some firms have included warnings advising investors not to rely on the calculations as a reasonable expectation of what they may receive in return.

Costs

Costs must be presented by their impact on projected returns averaged over the holding period. All direct and indirect costs incurred by an investor in the fund must be included, including one off, ongoing and incidental costs such as transaction costs (regardless of the fact that such costs would typically be recycled out of profits and reinvested).

Specific rules for the calculation of carried interest require a calculation on the basis of historical data for the previous five years, for any missing years on the basis of an estimated return, or if the fund is new, on estimated performance based on comparable funds or a peer group. Such information on competitor's funds is unlikely to be available (ironically, other than through KIDs that are publicly available).

The Future

It is hard to argue against cost and performance transparency between fund managers and investors. However, the varying disclosure requirements of PRIIPs, MiFID II, ILPA and the impending product of the FCA's Institutional Disclosure Working Group risks requiring fund managers to process and present similar data in a range of formats, with little corresponding benefit to fund investors.

The PRIIPs regulation specifies a review four years after implementation. Bringing forward that review seems justified and would be widely welcomed.

10.

SM&CR Transitional Arrangements: Impact on Private Equity

Paul Ellison, Macfarlanes

10. SM&CR Transitional Arrangements: Impact on Private Equity

Paul Ellison
Macfarlanes

The FCA proposes to extend the Senior Managers and Certification Regime ("SM&CR") to almost all financial services firms, including private equity firms. The FCA has published a consultation paper (the "Consultation Paper")[7] on transitioning FCA firms and individuals to the SM&CR. This article provides an overview of the FCA's proposed transitional arrangements and, in particular, the matters that specifically affect private equity and venture capital firms. An overview of the extension of the SM&CR was provided in a previous Technical Bulletin[8].

Key proposals and impact on private equity firms

Overall the FCA's proposals in the Consultation Paper are welcomed as providing needed clarity to firms within scope of the extended SM&CR. However, private equity firms should take note of the following proposals as part of their SM&CR implementation project.

(i) Conversion of existing approved persons

The FCA proposes automatically to convert most of the approved persons at Core and Limited Scope firms into the corresponding new senior management functions ("SMFs"). The FCA has proposed the following function mapping table for this purpose (as relevant to private equity firms).

Current controlled function	Possible corresponding SMF
CF1 – Director	SMF3 – Executive Director
CF2 – Non-Executive Director	SMF9 – Chair
CF3 – Chief Executive	SMF1 – Chief Executive
CF4 – Partner	SMF27 – Partner
CF10 – Compliance Oversight	SMF16 – Compliance Oversight
CF11 – Money Laundering Reporting Officer	SMF17 – Money Laundering Reporting Officer

This means that the majority of firms will not need to submit anything to the FCA to make conversion happen. However, where a non-executive chair is currently approved as a CF2, the firm will, exceptionally, need to submit a conversion notification (Form K) to convert the CF2 to SMF9. This is because the FCA will not necessarily know whether the non-executive is currently a performing the chair function.

[7] Individual accountability: Transitioning FCA firms and individuals to the Senior Managers & Certification Regime (CP17/41) (December 2017)
[8] BVCA Technical Bulletin: November 2017 – available here

A number of existing functions at Core and Limited Scope firms will not be automatic. This is because these roles will no longer require approval by the FCA. However, some of these roles will fall within the Certification Regime, for example: CF2 (Non-Executive Director); CF10a (CASS Oversight Function); CF28 (Systems and Controls); CF29 (Significant Management Function); and CF30 (Customer Function). Enhanced firms will need to submit a conversion notification and accompanying documents for all conversions. However, we consider that the vast majority of private equity firms will not fall within the Enhanced Regime.

The content and timings within the proposed transitional arrangements and the FCA's proposed approach are generally welcomed. For private equity firms, the proposals create needed certainty and reduce the potential administrative burden that would be associated with requiring non-Enhanced Firms to submit conversion documentation.

(ii) Statements of Responsibilities ("SoRs")

Although the FCA proposes to convert most approved persons automatically, every converted Senior Manager at a Core or Limited Scope firm must have a SoR ready at the time of conversion. This is the case even though the firm does not have to submit the SoR to the FCA on an automated conversion. However, individuals at Enhanced firms will be converted from an approved person function to the relevant SMF subject to the submission of a conversion notification, including a SoRs and a responsibilities map. However, as discussed above, we do not consider that many private equity firms will be Enhanced firms.

a. Certified staff

The Conduct Rules will apply to certified staff from the first day of the new regime applying. However, firms will have 12 months to complete their fitness and propriety assessment of certified staff and get the certification paperwork in place. The FCA has confirmed that firms will not be required to obtain regulatory references for existing employees who will be performing the same role after the start of the new regime.

b. Other Conduct Rules staff

The FCA proposes to give firms 12 months from the start of the new regime to apply the Conduct Rules to their other Conduct Rules staff (that is, those not holding a Senior Manager Function or a Certification Function). This should provide private equity firms with a longer period in which to ensure that Conduct Rules staff are adequately trained in the new rules.

c. Updated forms

When the new regime is implemented, there will be a number of new and amended forms for use by firms, which can be submitted through the FCA's Connect system. The FCA has proposed amendments to the fitness and propriety questions that must be completed as part of the approval process. In particular, there is the welcome clarification of a 10-year time limit to the period in which an individual has to declare if a firm in which the individual has held a position of influence has been party to civil proceedings.

Form REP008 (submitted using Gabriel) is used by most firms subject to the existing SM&CR to notify the FCA and the PRA where they have taken disciplinary action because of a breach of the Conduct Rules by Certified staff and other Conduct Rules staff. REP008 is not used with respect to breaches by Senior Managers. The FCA proposes to extend the use of the REP008 to all solo-regulated firms. The FCA also proposes to require firms to confirm that their staff have not breached any Conduct Rules in the form of the submission of a "nil return" and fees will be imposed on late or non-submitters of REP008.

The private equity industry's main concern with requiring all SM&CR firms to submit REP008 is the lack of a materiality threshold for reporting Conduct Rules breaches. Given the positive nature of this obligation on firms, there is an argument that there should be a greater sense of materiality in determining when and how to report Conduct Rules breaches. Although there is a similar reporting requirement under the approved persons regime, the existing requirement captures a much smaller population of employees than the SM&CR.

The proposal regarding the submission of a nil return is also considered by some to be excessive. As drafted, the severity of the breach and the seniority of the individual are not taken into account. An alternative approach would be: (1) to limit this periodic obligation to Certified staff; and (2) for other Conduct Rules staff, notifications should be event-driven and firms should only report material Conduct Rule breaches by such employees. It could be argued that for such event-driven notifications it would also be more appropriate for firms to use Connect to submit information to the FCA, rather than Gabriel (which is designed for regular, scheduled reporting).

d. Appointed Representatives

The SM&CR does not apply to appointed representatives ("ARs") (except for certain limited permission consumer credit firms that also act as ARs for other business). This is because the underlying legislation does not currently provide the FCA with the power to extend the regime to ARs. Therefore, any private equity firms who currently operate as an "adviser/arranger" (for example, where a fund is managed offshore) as an AR of a host principal firm (rather than being directly authorised and regulated by the FCA) will remain subject to the existing approved persons regime for the time being. However, since this will create something of an anomaly, it may be that this is an area HM Treasury may seek to revisit with legislative amendments in future.

Next steps and timing

The Consultation Paper closed for comments on 21 February 2018. The FCA aims to publish a policy statement in summer 2018. However, the date for the implementation of the new rules will be set by HM Treasury "in due course". For the purpose of the FCA draft rules that form part of the Consultation Paper, the FCA has assumed that the rules will apply to solo-regulated firms, including private equity firms, from mid-to-late 2019. This provides financial services firms, including the private equity industry, with longer than was previously expected to prepare, and implement changes, for the SM&CR.

11.

Omnibus proposals: Cross-border distribution of funds

Tim Lewis, Travers Smith

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Introduction

On 12 March 2018, the European Commission published legislative proposals for a new Omnibus Directive and Omnibus Regulation, which form part of its overarching Capital Markets Union Action Plan. The stated aim of the Directive and Regulation is to remove barriers to the cross-border distribution of investment funds by amending the existing provisions in AIFMD, the UCITS Directive and the EuSEF and EuVECA Regulations.

This is a commendable goal. However, as with any new legislative proposal, the success of the Commission's project depends upon whether its proposed changes fit the market they are seeking to regulate. Unfortunately, a number of elements of the draft Omnibus Directive and Omnibus Regulation run directly contrary to global private equity and venture capital fundraising practice. Some of the proposed amendments would increase the regulatory barriers to cross-border marketing activities if they are adopted in their current form. That would be a disappointing outcome for general partners and investors.

The key issues are discussed in further detail below.

New definition of "pre-marketing"

Currently, different EU Member States have different interpretations of what constitutes "marketing" under the AIFMD. Many countries, including the UK, treat "marketing" as taking place at an advanced stage of discussions with investors relating to a fund raising. This is helpful because of the obligations imposed on an EU private equity manager authorised under AIFMD (an "EU AIFM"):

- Prior to an EU AIFM "marketing" an EU private equity fund in its home member state, it must file fund documents with its home state regulator. These documents are typically only ready at an advanced stage of the marketing process;
- Prior to an EU AIFM "marketing" an EU private equity fund elsewhere in the EU, the EU AIFM must file a marketing passport application with its home member state regulator;
- Material changes to the initial documents must also be filed with the regulator and investors cannot be closed on the basis of those documents until a "wait period" has passed. Having to file multiple versions of the documents would impose an additional burden on EU AIFMs.

However, there is a downside to the approach of marketing being treated as happening late in the process. This is that AIFMD does not contain an express right for EU AIFMs to contact potential investors before their marketing. This prior contact is sometimes referred to in the market as "pre-marketing". Whether or not any "pre-marketing" activities can be lawfully carried on in a particular jurisdiction is generally a question of national law. Different member states have taken different approaches to the question of when pre-marketing is deemed to take place and whether it is permitted.

These issues are also relevant to non-EU AIFMs. Where a Member State operates a national private placement regime ("NPPR") (for EU AIFMs of non-EU funds and/or for other AIFMs), the concept of "marketing" is relevant to same definition of marketing is likely to be used as the trigger for requiring those managers to register under the local national private placement regime.

In order to try to address these issues, the Commission is proposing to define “pre-marketing” under AIFMD. Strictly speaking, this new definition applies only to authorised EU managers, but it could impact the approach to marketing under the NPPRs as well.

Under the proposed definition, a private equity manager’s fundraising activities will only amount to pre-marketing (and therefore would not constitute marketing) where they involve:

- a direct or indirect provision of information on investment strategies or investment ideas
- made by the manager itself or by another person on its behalf
- to professional investors domiciled or registered in the EU
- in order to test the interest of those investors in a fund which is not yet established.

In addition, the Commission is seeking to introduce new rules that would mean that a manager would not be pre-marketing (and therefore would be marketing) where it is providing draft prospectuses, offering documents, other constitutional documents or subscription forms in relation to funds that have not yet been established.

The proposal does not strictly speaking amend the definition of marketing. However the risk is clearly that authorities re-interpret “marketing” to “fit” with the new “pre-marketing” definition. On that approach, the proposal draws the line between pre-marketing and marketing early in the fundraising process and could raise practical challenges.

Limited partnerships are often formed early in the fundraising process, prior to substantive discussions with prospective investors, in order to facilitate time-consuming practical steps such as registering fund bank accounts, forming the broader fund structure and registering entities with tax authorities. If the current proposal is adopted, it will be important that these administrative processes are not treated as “establishing” the fund, otherwise the “pre-marketing” concept could be largely redundant.

The fundraising process frequently involves iterative negotiations with investors where various draft copies of the limited partnership agreement (“LPA”) are provided in order to demonstrate the indicative terms offered. During these initial ongoing negotiations, there is no “finalised” investment product being offered by the private equity manager and therefore no contractual offer is made to prospective investors. This is reflected under the current FCA approach, which does not treat these discussions as AIFMD “marketing”.

However, under the new “pre-marketing” rules proposed by the Commission, even these preliminary discussions would constitute marketing because draft LPAs or other documents (e.g. draft subscription documents containing proposed investor warranties) are being provided to investors. This would mean that the manager would need to make a marketing passport notification to the FCA (or, if the new definition is also carried across into the NPPRs, register with the FCA under the NPPR) at a much earlier stage in the process. In turn, this is also likely to require the manager to make multiple material change notifications when going back to prospective investors with subsequent revised drafts of the LPA or other updated materials. Since each material change notification triggers a potential 30-day approval period before the changes to the documents can become effective, this could make the current practice of iterative negotiations highly protracted without conferring any benefit on investors.

The new “pre-marketing” definition also raises practical questions for the FCA and other EU regulators. If a private equity manager must apply for marketing approval before it can circulate draft LPAs or similar documents to investors and/or before it can legally establish the fund partnerships, it is unclear which information or documents the regulator will require to process an approval. In the past, many regulators have refused to accept marketing applications until the fund vehicles have been established – that practice, at least, would clearly need to change.

The Omnibus Directive also effectively provides that any subscription by investors as a result of "pre-marketing" in a new fund with "similar features" to the one that is the subject of that pre-marketing cannot be deemed to have resulted from reverse solicitation. This would mean that fund managers would need to be very careful about having preliminary discussions with investors if they may be seeking to rely on reverse solicitation in the future so as to fall outside the AIFMD marketing regime in relation to similar funds.

Equivalent changes in relation to the new "pre-marketing" definition are also proposed for the EuVECA Regulation and therefore will affect EuVECA managers.

Withdrawal of marketing notifications

AIFMD does not currently define when a manager should be considered to have ceased marketing in a Member State. This is important because a manager can only withdraw a marketing notification (i.e. "switch off" its passport or rights right to market under the NPPR) when it is no longer marketing in a jurisdiction. It may be desirable to switch off the passport where, for example, a Member State charges ongoing fees in connection with the exercise of marketing rights in its jurisdiction.

Private equity fund managers and their investors may think it obvious that following the final closing of a fund, AIFMD treats marketing as having ceased. Unfortunately the European Commission seems to have reached a very different conclusion.

The Omnibus Directive introduces new rules which state that a fund manager can only withdraw a marketing notification in a Member State where all of the following conditions are met:

- there is a maximum of 10 investors in that Member State who hold in aggregate no more than 1% of the assets under management of the fund;
- the fund manager makes a public blanket offer for at least 30 working days to repurchase (free of any charges or deductions) all units in the fund held by investors in that Member State; and
- the fund manager publicly advertises that it intends to cease marketing in the jurisdiction.

These conditions are clearly impractical for private equity funds, given that they are closed-ended in nature, typically invest in illiquid assets on a long-term basis and generally operated by AIFMs who are unlikely to have the resources to buy out their investors! Similarly, funds are not designed to have sufficient excess cash to buy out investors or to be able to liquidate its investments in order to do so. It is also unclear how this requirement interacts with other regulatory requirements – for example, the requirement in AIFMD to treat all investors fairly, given that the fund will be buying out certain investors in one jurisdiction when other fund investors have no such redemption rights. The Omnibus Directive is also silent on the mechanism for determining the price of buying back the investors' interests, other than that no fees or deductions may be applied.

Where investors choose to remain invested in the fund despite the offer to buy them out, the fund manager must continue to provide them with the relevant investor transparency information under AIFMD, such as fund annual reports.

Some EU Member States already take the view that an EU manager cannot deactivate the marketing passport in their jurisdiction where the manager has picked up investors in the relevant fund. Where that is the case, the Commission's addition of onerous (and in the private equity context, largely impractical) new preconditions to deactivation of the marketing passport will have little practical effect – i.e. the fund manager would not be able to deactivate the passport anyway. However, to the extent that jurisdictions have to date permitted the marketing passport to be withdrawn following the cessation of marketing, notwithstanding that the fund has attracted investors in the relevant Member State, this would represent a significant change.

It would be more concerning if the new proposals interfered with the ability of EU managers to deactivate the marketing passport even where they had not attracted any investors in the relevant jurisdiction. The current drafting is somewhat ambiguous in this regard, but could be read as requiring the manager to publicise the fact that it is ceasing to market in the relevant Member State and introducing a new notification process which could lead to delays of up to 20 working days before deactivation can occur.

Marketing fees and charges

There is an ongoing debate about whether AIFMD permits national regulators to impose fees and charges in connection with the exercise of the marketing passport into their jurisdictions. Some jurisdictions do impose such charges (which can be substantial, particularly where levied separately on each relevant fund vehicle), while others, such as the UK, do not.

The Omnibus Regulation will expressly permit national regulators to impose fees or charges on managers in connection with authorisation, registration or the exercise of supervisory or investigatory powers. The only express limitation is that any such fees or charges must be proportionate to the expenditure incurred by the relevant regulator. Where a national regulator does impose fees, it must publish on its website a central database of any such fees (or the relevant calculation methodologies for determining them).

While additional transparency on fees and an express requirement that any fees should be proportionate may seem like welcome developments, it is nonetheless possible that these new provisions will be taken as express permission for national regulators to impose fees where they do not currently do so. This has led to concerns that more regulators will begin to charge fees for activating and maintaining the marketing passport in their jurisdictions.

The irony of this development will not be lost on industry participants who when invited to raise concerns with the European Commission about barriers to the single market under AIFMD, raised the existence of these charges as a concern with a view to supporting the development of the single market.

Other proposals

The Omnibus Regulation introduces certain other new requirements for marketing communications. Many of these are unlikely to have a significant impact on current practices, although there will be a new requirement for managers to ensure that they present the risks and rewards of purchasing units in a fund in an “equally prominent manner”, which may require some additional consideration of marketing materials. ESMA will be empowered to issue new guidelines to supplement the marketing requirements, which, depending on their content, may have a more significant impact on marketing practices in the future.

National regulators in EU Member States will also gain the power to require fund managers to notify them of any marketing communications they intend to use for the purposes of marketing in that jurisdiction. The relevant national regulator will then have 10 working days to request that the manager make changes in order to ensure that the communication complies with the AIFMD marketing rules. However, national regulators cannot make such notifications a pre-condition for marketing in their territories, so the fund manager may begin marketing in the relevant Member State during that period. If Member States choose to exercise this option, fund managers may see greater scrutiny of marketing materials and possible requests to make amendments deemed necessary by regulators.

The Omnibus Regulation also introduces new minimum requirements where a Member State permits marketing to MiFID retail investors, whether under the marketing passport or the NPPRs. In summary, these would require the manager to provide, or to appoint a regulated entity to provide, certain paying agent-like services where it intends to market the fund to retail investors in the relevant jurisdiction. In practice, many fund managers will seek to avoid marketing to prospective retail investors in order to avoid the application of the PRIIPs Regulation and the requirement to prepare a Key Information Document. However, these requirements would become relevant if the manager were marketing to investors who do not benefit from, and cannot be opted-up to, MiFID professional status (e.g. some high net worth individuals, certain family office structures or potentially some local authority entities).

Next steps

The consultation period for the Omnibus proposals closed on 7 May 2018. The BVCA, through its involvement in Invest Europe, has provided feedback on the key elements of the proposals and has particularly emphasised the need for the new legislation to be amended in order to reflect the mechanics of the private equity fundraising model.

The precise timescale for the new proposals to enter into force is not yet clear. As currently drafted, most of the changes would apply from two years after the new legislation is enacted, which suggests a current likely implementation date of around mid-2021. However, if the legislative process accelerates, the earliest realistic date for implementation of the key requirements (on the basis of the current drafting) would be towards the end of 2020.

The Omnibus proposals remain relevant to UK private equity managers despite Brexit. At the present time, the nature of the end-state relationship between the UK and the remaining EU Member States is unclear, but even if the UK is treated as a standard “third country” after Brexit, many of the proposals are likely to have a knock-on impact on Member States’ NPPRs (to the extent that they are available).

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