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40 YEARS

Policy & Technical Bulletin

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

November 2023

Contents

Introduction

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

Over the last year, our industry has continued to respond to the challenging economic climate and geo-political environment. The Prime Minister has marked one year since taking office, and along with the Chancellor of the Exchequer, has sought to bring economic stability.

Growth has been a central feature of the government's economic agenda and is exemplified by the Mansion House reforms, announced by the Chancellor in July, to unlock £50bn of capital by 2030 through changes to the UK pensions industry. These measures seek to increase returns for pension savers and support growth across the UK economy.

As part of the reforms set out by the Chancellor, nine of the UK's largest pension funds have committed to allocating at least 5% of their default funds into unlisted equities by 2030 as part of the Mansion House Compact. The Mansion House Compact has since received two additional signatories to take the total number of pension funds to eleven. The UK is often recognised as a leading environment to start a business, but often falls behind other countries as a suitable environment to scale-up and grow. The measures set out by the Chancellor seek to increase liquidity, particularly for high-growth companies, and strengthen the UK as a place where businesses can successfully grow.

The BVCA welcomed the reforms set out at Mansion House and launched the Venture Capital Investment Compact in October (the "VCIC" or "Compact") to complement the Mansion House Compact. The Exchequer to the Treasury, Gareth Davies MP, hosted the BVCA and twenty initial signatories at a roundtable to formally launch the Compact. It has since been signed by 50 UK venture capital and growth equity firms and will be a key area of work for the BVCA over the next year to progress the delivery of the commitments set out in the Compact.

This edition of the Bulletin has been published prior to the Autumn Statement announcement and therefore does not reflect any of the announcements made. The BVCA will provide members with a further update on the measures set out.

Since the last edition of the Bulletin, the BVCA has welcomed Sarah Adams and Isobel Clarke as the new Directors of Policy. Sarah and Isobel joined in July as a job-share partnership from HM Treasury and are leading the Policy team across tax, legal, regulatory, accounting and sustainability matters, working with members and the BVCA committees to progress key technical and strategic policy issues.

Authors

Victoria Sigeti
Chair, Legal & Accounting Committee

Maria Carradice
Chair, Taxation Committee

Tim Lewis
Chair, Regulatory Committee

Jonathan Martin
Chair, Accounting, Reporting & Governance Committee

Sarah Adams
Director of Policy, BVCA

Isobel Clarke
Director of Policy, BVCA

Introduction

Over the last six months, the Taxation Committee has continued to monitor developments and engage with key stakeholders on domestic and international tax issues. Work continues on Pillar Two both at the OECD and within national governments; the implications for private capital are discussed in this Bulletin by Abigayil Chandra, Julie Garside and Ollie Smith. Tax remains an active policy area for the EU, described in this Bulletin by Laura Charkin and Matthew Rees. The BVCA is grateful, in this context, for the vital work of Invest Europe with policymakers in Brussels.

Other active policy areas on which the Taxation Committee has made recent submissions include: the government's proposal to merge the existing R&D tax relief schemes; the reform of stamp taxes on transfers of shares; changes to the definition of a permanent establishment to align more closely with the OECD; and tax administration issues relating to HMRC's use of data. The committee also published a detailed Policy & Technical Guide for members on the qualifying asset holding company regime, providing guidance on the rules that is specifically tailored to the private capital industry.

The Regulatory Committee has continued to engage with the FCA on several areas including retailisation and sustainability regulation. The committee maintains effective engagement with the regulator's supervisory team to provide feedback from firms on the implementation of regulatory requirements. In this Bulletin, the committee explores the impact of regulatory developments in Europe.

Stephanie Biggs covers the AIFMD II loan origination regime, which was agreed in October 2023. The requirements of the regime is applicable to EU AIFMs that manage funds that originate loans. The new regime includes a regulatory framework specifically for EU funds that engage in loan origination activities. The timeline for implementation and key elements of the regime are summarised in this article.

In this Bulletin, Paul Ellison provides an update on Retailisation, with a particular focus on the Long-Term Asset Fund (LTAF) and the European Long-Term Investment Fund (ELTIF). The opportunity for retail investors to access to both vehicles has increased following amendments to both entities and has provided private capital fund managers with access to new sources or investment capital, widening their existing investor base.

Sustainability has remained a key area of focus for regulators in the UK and EU, requiring firms to consider the additional requirements that need to be reflected through the existing reporting process. The increase in regulatory requirements from the EU is covered by Patricia Volhard and John Young, who provide an update on the Corporate Sustainability Reporting Directive (CSRD) and its applicability to portfolio companies, private equity funds and sponsors.

The Legal & Accounting Committee has been separated to form two new committees: the Legal Committee and the Accounting, Reporting & Governance Committee. The committees will provide a dedicated forum for two important areas of focus for industry. To ensure alignment, both committees will convene a joint meeting once a year.

In this Bulletin, the Chair of the Accounting, Reporting & Governance Committee, Jonathan Martin, along with vice-Chair, Karen Sands and BVCA Policy Manager, Ciarán Harris, introduce the committee and provide an outline of the key topics on the committee's agenda. This includes the UK Sustainability Disclosure Standards and the FRC Ethical Standard revisions.

Following representations to the US regulator, the Legal Committee was successful in supporting the BVCA efforts to prevent the new rules catching typical UK firms, joining legal advisors, GPs and Invest Europe against certain 'extra-territorial' provisions. Chris Bulger provides insight into the SEC's new Private Fund Adviser Rules as announced in August 2023. The impact of the new rules will still need to be considered by firms, with further requirements to provide investors with quarterly statements on several areas including fund fees, new restrictions on general partner clawbacks and expenses and performance.

To conclude this Bulletin, Jonny Myers and Katherine Ellis provide our regular case law update. Please note that the Legal Committee and the new Accounting, Reporting & Governance Committee continue to publish accounting and legal updates, which are available on the BVCA website.

Introduction

For more detail on the full spectrum of policy issues the BVCA and our technical committees continue to work on, head to the policy section of our website where key policy content is accessible to members and other stakeholders. As well as summarising our work on key tax, legal, regulatory, and accounting files, there is a section dedicated to sustainability, governance, and disclosure. View policy pages here.

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 like to extend a particular thank you to Mark Baldwin, who has stepped down as chair of the Taxation committee after many years of dedicated commitment. The Taxation Committee has welcomed Maria Carradice as its new chair.

- Victoria Sigeti, Chair, Legal & Accounting Committee
- Maria Carradice, Chair, Taxation Committee
- Tim Lewis, Chair, Regulatory Committee
- Jonathan Martin, Chair, Accounting, Reporting & Governance Committee
- Sarah Adams & Isobel Clarke, Directors of Policy, BVCA

	New members on our committees	Members who stepped down
Legal & Accounting Committee	**Angus Miln** (Taylor Wessing) **Veronica Robers** (Herbert Smith Freehills)	
Taxation Committee	**Catherine Watkins-Wright** (Bridgepoint) **Laura Underhill** (Clifford Chance) **Alex Christoforou** (EY)	**Mark Baldwin** (Macfarlanes) **Anthony Stewart** (Clifford Chance) **Farhana Raval** (Bridgepoint) **Graham Taylor** (EY) **Michael McCotter** (Charterhouse)
Accounting, Reporting & Governance Committee	**Committee established in September 2023** (Members set out on p7)	

Introduction

Submissions over the past six months

The list below highlights the submissions the BVCA has made and contributed to since the start of June 2023 (as our last Bulletin was published in May 2023). You can find all of the BVCA's policy submissions here and the Invest Europe submissions here. Invest Europe regularly gathers representatives of national PE/VC associations across Europe and represents the views of the PE/VC industry in EU-level public affairs/policy.

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

Committee	Specific consultation topic
Taxation	• Draft R&D legislation – HMT • Transfer pricing, permanent establishments and the diverted profits tax – HMRC • Pillar two draft legislation and guidance – HMRC • Tax Administration Framework review – information and data – HMRC • Stamp taxes on shares modernisation - HMRC
Regulation	• HM Treasury Call for Evidence on the Senior Manager & Certification Regime – HMT • FCA DP23/2 on updating and improving the UK regime for asset management – FCA
Legal	• Primary Markets Effectiveness Review: Feedback to DP22/2 and proposed equity listing rule reforms – FCA • US Treasury ANPRM – U.S. Investments in Certain National Security Technologies and Products in Countries of Concern – US Treasury
Accounting, Reporting & Governance	• The UK Sustainability Disclosure Technical Advisory Committee Call for Evidence – FRC • FRC Consultation on Ethical Standard – FRC • FRC non-financial reporting review call for evidence – FRC
Cross-committee	• Autumn Statement 2023 submission – HMT • LGPS: next steps on investments – DLUHC • Options for Defined Benefit schemes – DWP • Ending the proliferation of deferred small pension pots – DWP • Call for evidence on trustee skills, capability and culture – DWP • Letter to MPs regarding ECCT Bill – Failure to prevent fraud and anti-money laundering amendment – Home Office • FCA proposed amendments to ban on incentives - FCA

Accounting, Reporting & Governance Committee

Name	Company
Jonathan Martin (Chair)	KPMG
Karen Sands (Vice-Chair)	Federated Hermes GPE
Adam Snazel	3i
Ashley Coups	EY
Catherine Lester	TDR Capital
Charlotte Pettit	Just Climate
David Plant	Bridgepoint
Jennifer Lisbey	Pantheon
Lucy Reeve	Linklaters
Neal Griffith	Equistone
Neel Mehta	Primary Capital
Raj Hussain	CVC Capital Partners

Name	Company
Richard McGuire	PwC
Rikesh Parmar	Cinven
Sam Pointon	Grant Thornton
Simon Witney	Travers Smith
Sofiya Kichkova	Ares Management
Stephen Kempen	Apax
Stuart Clowser	RSM
Tim Spence	Graphite Capital
Tushar Pabari	Mayfair Equity Partners
Vanessa Bradley	BDO
Vikas Karlekar	ICG
Yasir Aziz	Deloitte

Legal Committee

Name	Company
Victoria Sigeti (Chair)	Freshfields Bruckhaus Deringer
Alastair Richardson (Vice-Chair)	3i
Angus Miln	Taylor Wessing
Ann McCarthy	BGF
Babett Carrier	Cinven
Benjamin Marten	Bridgepoint
Camilla Barry	Macfarlanes
Chris Bulger	Vitruvian Partners
Clare Gaskell	Simpson Thacher & Bartlett
Ed Hall	Goodwin Procter
Elizabeth Judd	STAR Capital

Name	Company
Geoffrey Kittredge	Debevoise & Plimpton
Harris Kaufman	Ares Management
Helen Croke	Ropes & Gray
Jeremy Dennison	Livingbridge
John Heard	Abingworth
Jonny Myers	Clifford Chance
Matthew Keogh	Linklaters
Matt O'Toole	CVC Capital Partners
Nick Reid	Carlyle
Veronica Roberts	Herbert Smith Freehills

Regulatory Committee

Name	Company
Tim Lewis (Chair)	Travers Smith
Mark Howard (Vice-Chair)	KKR
Aisling Malone	Bain Capital
Andrew Lewis	ICG
Ed Kingsbury	CMS
James Smethurst	Freshfields Bruckhaus Deringer
Jason Pae	Bridgepoint
John Decesare	3i
John Morgan	Pantheon
Lindsay Hamilton	Livingbridge
Lisa Cawley	Kirkland & Ellis
Owen Lysak	Simpson Thacher & Bartlett
Patricia Volhard	Debevoise & Plimpton
Paul Ellison	Clifford Chance
Peter Moore	Cinven
Shailen Patel	Macfarlanes
Simon Powell	Advent International
Tom Bowie	Molten Ventures
Baaldesh Bajit Singh (Secondee)	Travers Smith

Taxation Committee

Name	Company
Maria Carradice (Chair)	Mayfair Equity Partners
Abigayil Chandra (Personal Tax Sub-Committee Chair)	Deloitte
Clare Copeland (Corporate Tax Sub-Committee Chair)	Carlyle
Alex Christoforou	EY
Alexander Conway	Crowe
Alexander Cox	Kirkland & Ellis
Alexandra Hone	ICG
Brenda Coleman	Ropes & Gray
Catherine Watkins-Wright	Bridgepoint
Charles Osborne	Slaughter & May
Craig Vickery	Exponent
Ed Nevens	Cinven
Elaine Gwilt	KPMG
Garry O'Neill	3i
Graham Iversen	Greenberg Traurig
James Pratt	BDO
James Sanderson	Vitruvian Partners
Jenny Wheater	Debevoise & Plimpton

Name	Company
Jessica Haigh	Permira
Jill Hardie	Aberdeen Standard Investments
Jonathan Page	PwC
Jono Clare	Livingbridge
José Maria Palicio	Permira
Josh Griffin	Inflexion
Julian Nelberg	Andersen
Laura Charkin	Goodwin
Laura Underhill	Clifford Chance
Matthew Saronson	Debevoise & Plimpton
Patricia Allen	Ashurst
Richard Vitou	Deloitte
Russell Warren	Travers Smith
Stephen Pevsner	Proskauer
Terry Heatley	Grant Thornton
Tim Hughes	PwC
Tony Mancini	KPMG
Rhiannon Kinghall Were (Secondee)	Macfarlanes

01

Update on OECD Pillar Two

Abigayil Chandra, Julie Garside and Ollie Smith (Deloitte)

01 Update on OECD Pillar Two

This article builds on our previous piece, "How will the OECD Pillar Two rules affect you?" (BVCA Policy and Technical Bulletin, May 2023). It provides an update on recent developments, covers some key considerations for both funds and their managers, and describes the impact on the tax due diligence process.

Recap of the components of the Pillar Two rules

The OECD Inclusive Framework model Pillar Two rules apply to large multinational groups with annual consolidated group revenue of at least €750m. They have the following key components:

- An income inclusion rule (IIR) applies on a top-down basis such that tax due is (in most cases) calculated and paid by the ultimate parent entity (UPE) to the tax authority in its country. The tax due is the "top-up" amount needed to bring the overall tax on the profits in each country where the group operates up to the minimum effective tax rate (ETR) of 15%.
- The undertaxed profits rule (UTPR) will apply as a secondary (backstop) rule in cases where the ETR in a country is below the minimum rate of 15%, but the IIR has not been fully applied. The top-up tax is allocated to countries which have adopted the UTPR based on a formula, and is to be implemented by countries either by denial of a deduction for payments or by making an equivalent adjustment.
- The OECD model rules also allow for countries to introduce a qualified domestic minimum top-up tax (QDMTT). Under a QDMTT, top-up taxes in respect of any low-taxed profits of a group's entities in that country are payable domestically, rather than to other countries under the income inclusion or undertaxed profits rules.

Latest OECD developments

Work has continued at an international level throughout 2023 on the finalisation of the Pillar Two global minimum tax rules.

Safe harbours

The OECD Inclusive Framework has published helpful guidance on Pillar Two "safe harbours" to minimise the compliance burden for businesses.

The **transitional CbC reporting safe harbour** is a short-term measure to exclude a group's operations in lower-risk countries from the compliance obligation of preparing full Pillar Two calculations. It applies for up to three years and uses information taken from a business's country-by-country (CbC) report and financial statements to determine whether its operations in a country meet any of three tests: the de minimis test, effective tax rate test, and routine profits test. Where the transitional safe harbour applies, i.e. when any of these tests are satisfied, the top-up tax for that country will be zero.

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01 Update on OECD Pillar Two

The **permanent QDMTT safe harbour** will allow businesses to elect to prepare a single QDMTT computation for a country such that no additional top-up tax will arise under the IIR or UTPR, which provides a compliance simplification. In order for the safe harbour to apply, the domestic minimum tax must not only be "qualified," but the domestic legislation must also meet an additional set of safe harbour standards. QDMTT calculations are to be prepared using the accounting standard of the consolidated financial statements of the ultimate parent entity (in line with the OECD Inclusive Framework model rules). Alternatively, QDMTT countries can require businesses to use a local financial accounting standard if specified conditions are met, including that all constituent entities located in the country prepare financial accounts based on the local standard. Businesses will not have the option of choosing which accounting standard to use.

Finally, under the **transitional UTPR safe harbour**, no top-up tax will be payable under the UTPR in respect of any undertaxed profits of a business in its UPE country if that country applies a statutory corporate income tax rate of at least 20%. This safe harbour is to accommodate countries while they introduce their legislation and is particularly important for, for example, US-parented groups. This is a temporary safe harbour and will mean that the UTPR will not apply to such parent country profits until fiscal years beginning in 2026.

GloBE information return

The OECD Inclusive Framework has developed the standardised information return to be filed by businesses within the scope of the OECD model rules. The information return will include a comprehensive set of data points required for a tax authority to evaluate the correctness of a business's calculation of its top-up tax liabilities in each country.

In order to allow businesses time to put systems in place, where conditions are met the information return framework includes a "transitional simplified jurisdictional reporting framework" for the first five reporting years of the regime (i.e., returns for fiscal years beginning on or before 31 December 2028). For example, where there is no top-up tax liability for a country, a business can elect to report the majority of the required data on a net/aggregated basis, rather than for each constituent entity.

Administrative guidance

The OECD Inclusive Framework has published two sets of "Agreed Administrative Guidance" in 2023 and has committed to publishing further guidance on a rolling basis to clarify the interpretation and operation of the rules. OECD Inclusive Framework member countries are required to apply Pillar Two consistently with this guidance. The latest July 2023 administrative guidance includes guidance on currency conversion, the treatment of tax credits, the substance-based income exclusion for routine profits, and QDMTTs.

Subject to tax rule

The Pillar Two framework also includes a standalone subject to tax rule (STTR), a model treaty provision to allow developing countries to amend their treaties to impose limited additional taxation on some cross-border payments (including interest, royalties, and intra-group services). The payments affected are those between connected companies where the recipient is subject to a statutory or regime corporate tax rate below 9%. It operates as a tax on the gross amount of the payment, and therefore has some similarities to a withholding tax, but is not withheld from the payment - instead it is assessed on an annual return.

The STTR applies to all businesses (subject to de minimis payments amounts) and is not limited to businesses meeting the €750m revenue threshold used elsewhere in Pillar Two. The STTR takes priority over the IIR, UTPR, and QDMTT, and any STTR amounts paid are creditable under those rules. A multilateral convention to facilitate the implementation of the STTR within relevant existing bilateral tax treaties is now open for signature.

Implementation status

Many countries are in the process of implementing the OECD Inclusive Framework model rules in their domestic legislation and the IIR and QDMTTs will begin to apply from 2024 in some countries, with the UTPR expected to apply no earlier than 2025.

01 Update on OECD Pillar Two

The UK enacted initial legislation in respect of the UK's domestic implementation of an IIR (multinational top-up tax) and a QDMTT in July 2023. The multinational top-up tax and UK QDMTT will have effect in the UK in respect of accounting periods beginning on or after 31 December 2023. Draft legislation has also been published for a "backstop" UTPR. The start date for the UTPR is to be confirmed at a later date, but the UTPR will take effect no earlier than 2025. The UK is committed to ensuring that the UK legislation remains in line with the latest agreed OECD Inclusive Framework model rules and administrative guidance and has also published further draft legislation for technical consultation.

Pillar Two and private capital managers

Private capital managers will need to consider Pillar Two both from the perspective of their funds and from the perspective of their own management group. The key steps in considering both levels of their structure will be:

1) Determine the scope of the rules (work out where MNE group(s) are in the structure)
2) Calculate the tax base (net GloBE income/loss)
3) Determine covered taxes
4) Calculate effective tax rate and top-up tax
5) Work out who collects the tax by applying the QDMTT, IIR and UTPR

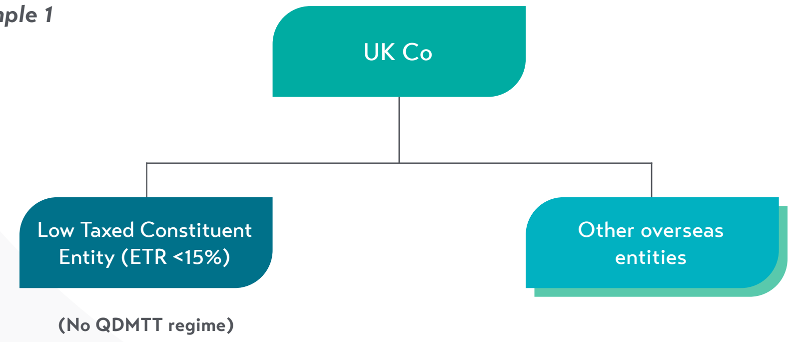
Private capital manager groups

Similar to the above, the first step for the manager group will be to determine where the MNE group is within its structure. Once established, work needs to be undertaken to consider:

1) Whether there are any excluded entities.
2) Whether there are any entities which fall within the safe harbours.
3) Whether there are any flow through entities, and if so, whether all the income of these entities can be allocated to their owners such that the flow through entities do not have any income for which there are no covered taxes.
4) Whether there are any consolidated investment entities such as investment funds, which are subject to special rules.
5) Whether there are any entities in low tax jurisdictions which may not have an ETR of more than 15%.
6) Whether any group entity jurisdictions have introduced an IIR, a UTPR or a QDMTT to determine where any top-up tax may be due.

The following examples set out some simple scenarios of how the IIR, UTPR and QDMTT rules could apply to a private capital manager's group.

Example 1

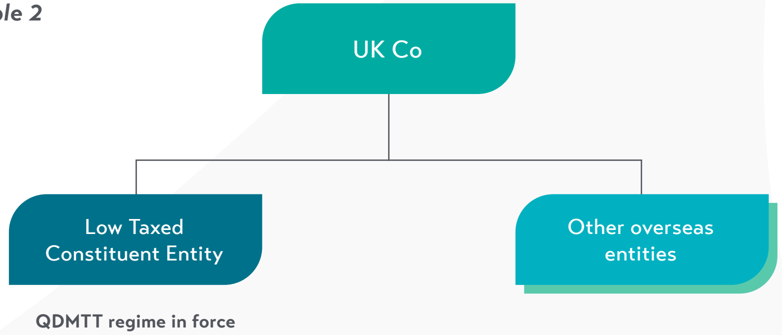


In this example:

- UK Co is the UPE as it consolidates all the other entities on a line-by-line basis and would need to pay any top-up tax due in relation to low taxed entities in its group (under the IIR).
- The IIR applies if the UPE holds ownership interests in the Low Taxed Constituent Entity (LTCE) at any time in the fiscal year – even if it is disposed of.
- If UK Co owned less than 100% of the LTCE, the top-up tax amount under the IIR would be apportioned.

01 Update on OECD Pillar Two

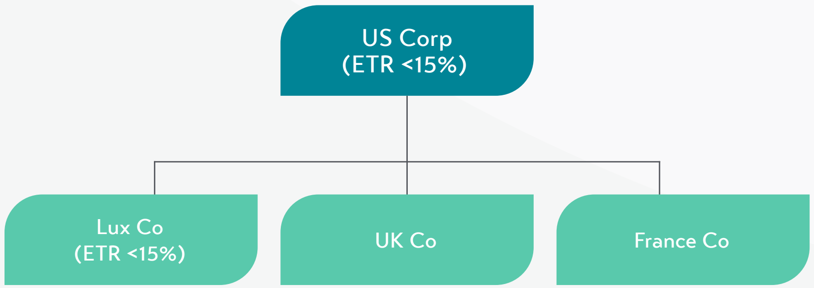
Example 2



In this example:
UK Co is the UPE (as it consolidates as above) and would need to pay any top-up tax due in relation to low taxed entities in its group (under the IIR).

- However, as the territory of the LTCE operates a QDMTT and tax is paid locally, the amount of top-up tax payable by UK Co under the IIR is reduced, possibly to £nil.

Example 3

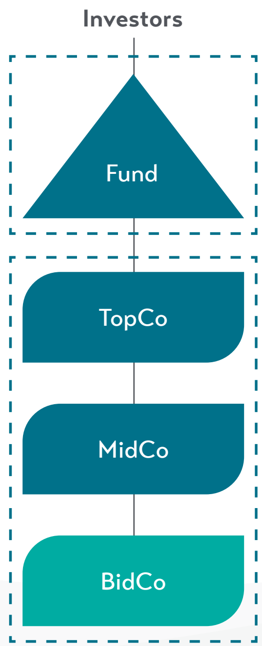


In this example:

- The US Corp is the UPE, has an ETR of less than 15% and as the US has not (yet) adopted Pillar Two, US Corp will not operate any top-up tax (IIR).
- There are no subsidiaries under UK/Lux/France and so no top-up tax under an IIR is operated at the UK/Lux/France entity level.
- UK Co (and other overseas entities that have introduced the UTPR) will pay top-up tax under the UTPR in respect of US Corp and Lux Co, both of which have a ETR of less than 15%.

Funds

As covered in our previous Pillar Two article, a key question for funds is how they will be classified and whether they fall within the definition of an excluded entity. In general, a fund will not be consolidating the results of its portfolio investments on a line-by-line basis and in such a case, the fund will not be a UPE nor meet the definition of an excluded entity.



However, it is unlikely that a fund would be considered an MNE unless it has a permanent establishment in another jurisdiction.

Therefore, ordinarily the key areas of focus for a fund will be on determining whether any of its holding entities or portfolio companies form an MNE group with a turnover of more than €750m.

One issue that a fund should also consider, particularly in the context of a "fund of one" or SMA structure, is whether the fund structure would form part of the MNE group of any of its investors. If so, it is possible that the fund structure or entities invested into could be exposed to top-up tax either through a QDMTT or UTPR charge which could reduce the economic returns that the fund (and its investors) receive. However, absent receiving any communications from the investor, the fund and entities in its investment structures may not have any visibility on whether it has an obligation to make such a QDMTT or UTPR payment at all (eg it may not know that the investor UPE is not subject to an IIR).

It is also noted that some QDMTTs may apply to structures that would not be within scope of Pillar Two. For example, the UK QDMTT can apply to purely UK domestic groups, where they have surpassed the revenue threshold. Where groups include investment funds consolidated on a line-by-line basis, income of these can count towards the revenue threshold, even though the investment fund may be an excluded entity itself.

Portfolio holding structures – identifying the ultimate parent entity

It will be important for a private equity investor to understand which entities in their portfolio holding structures are required to prepare consolidated accounts, as the top-most entity that prepares consolidated accounts on a line-by-line basis will be considered to be the UPE of the multinational group for Pillar Two purposes.

In most cases, it is likely that neither the fund nor many of its holding companies would be required to prepare consolidated accounts which consolidate portfolio group holdings on a line-by-line basis. However, it will be important to understand the reasons that a portfolio group holding is not consolidated on a line-by-line basis. Where this is due to the company applying investment entity accounting (for example, under IFRS 10 or a local GAAP equivalent) the company should not be considered the UPE of a multinational group for Pillar Two purposes.

In some instances, however, there might be other reasons why line-by-line consolidated accounts are not required (for example where there is no requirement for consolidated accounts to be prepared under local company law). Where this is the case, the Pillar Two rules require the company to consider whether line-by-line consolidated accounts would have been prepared if the company had been required to consider preparing them under company law.

The ultimate parent entity and the transitional CbC reporting safe harbour

As set out above, businesses are not required to prepare detailed Pillar Two calculations for countries where the safe harbour tests are met, based on country-by-country reporting data. Understanding which entity is the UPE of a multinational group is important to understanding whether the group for Pillar Two purposes is consistent with the group for which a country-by-country report has been prepared, so that any differences can be understood and their impact assessed.

Partially Owned Parent Entities (POPEs) and Minority Owned Parent Entities (MOPES)

Specific Pillar Two rules apply in some cases where constituent entities are not wholly owned by the group and these rules can make the impact of the Pillar Two rules on entities owned by multiple parties complex.

The POPE rules apply where the UPE holds less than 80% of a constituent entity and its sub-group. Pillar Two top-up tax can arise for the POPE as a result of a low ETR in an entity outside the POPE subgroup. This means that a minority investor in the POPE could be economically disadvantaged by the Pillar Two rules, on the basis that an entity it has invested in is effectively bearing a Pillar Two tax charge that relates to the majority investor.

Under the MOPE rules, a minority owned subgroup could be brought within the scope of a Pillar Two charge by virtue of being included within the consolidation of a wider multinational group, whilst as a standalone group, it would not be large enough to be within scope of the rules.

In an M&A context, it is not always straightforward to understand the impact of these aspects of the rules at the time of an investment being made – for example, the future Pillar Two charges that might arise in a POPE could be dependent on the future make-up and profile of the majority investor's wider MNE group, which they may be unwilling to share details of with a minority investor.

Given these dynamics, it is important to consider what provisions might be required in the transaction documentation (for example, within the shareholders' agreement) to manage the economic impacts of these elements of the rules, and agree an approach at the time of the investment.

Pillar Two and the tax due diligence process

Whilst there are currently no historical Pillar Two tax charges or filings to undertake tax due diligence on, the tax due diligence process will be critical for investors in trying to understand the Pillar Two profile of a group for tax modelling purposes at the time of a transaction.

Identifying whether the Pillar Two rules are expected to apply

As an initial step, it will be important for investors to establish whether the Pillar Two rules are likely to apply to an investment during the course of the holding period. This will likely depend on a number of factors, including:

- the existing size of the target group;
- the anticipated growth profile of the target group; and
- whether any bolt-on acquisitions are intended to be made to the target group, and if so the anticipated scale of these.

If it is anticipated that the Pillar Two rules will apply to the target group, it will be important for investors (including a fund) to consider what information might be obtained as part of the tax due diligence process to inform the Pillar Two modelling that may need to be included within the transaction tax model.

Obtaining Pillar Two information as part of the due diligence process

Obtaining the relevant information as part of the transaction process might be challenging at times, particularly if:

- the target is not expected to be subject to the Pillar Two rules on a standalone basis, as target management may not have given any consideration to Pillar Two; or
- if the target is being carved out from a wider group, as it might be difficult to obtain Pillar Two information that encompasses the target group entities only.

Given the nature of a transaction process, requesting the relevant information at the right time in the transaction process will be important – for example, in some cases it might be necessary to request Pillar Two information earlier in the transaction timetable than would be typical for tax due diligence queries, as it may take management more time to prepare answers than for other tax due diligence requests.

Due diligence and the transition period

As well as requesting information that will enable a fund or investor to understand the potential ongoing Pillar Two profile of a target group going forward, it will be important to use the tax due diligence process to identify whether any transactions have been undertaken by the target group during the transition period before the start of the Pillar Two rules which might require adjustments to be made under the Pillar Two rules.

01 Update on OECD Pillar Two

This could include intragroup transfers of assets or intellectual property, or group reorganisations that have been undertaken since 30 November 2021.

Transaction pricing for pricing dates after the Pillar Two rules come into force

For transactions where the pricing date falls after the Pillar Two rules come into force, consideration will need to be given to what Pillar Two related liabilities should be included within the pricing balance sheet for the transaction.

This might include both Pillar Two liabilities (under the IIR or UTPR provisions), and QDMTT charges in the jurisdictions in which the group operates.

It will be important to ensure that enough information is available for periods up to the transaction balance sheet date to enable these liabilities to be calculated.

Common acquisition matters that might impact the Pillar Two profile of a MNE group

When an acquisition is made, it is important to consider the implications of the acquisition and their tax impacts in the context of the Pillar Two rules to identify whether any adjustments to the Pillar Two tax profile of the group might be required following the transaction.

Some common elements of acquisitions that can impact the Pillar Two tax profile of a multinational group following the transaction include:

- transactions that result in a difference between the tax and accounting values of assets held by an entity for tax purposes;
- transactions following which there are differences between accounting (eg depreciation or amortisation) and tax deductions; and
- the application of local tax rules to foreign exchange gains and losses, which in some jurisdictions might be taxed once realised, rather than being taxed on an accruals basis.

Conclusion

In the context of private capital funds, their managers and the investments they make, Pillar Two is an issue that will need to be considered now (before the rules come into effect in the UK from the start of 2024), or borne in mind as management groups and investments grow over time and consolidated revenues move closer to the €750m threshold for the rules to apply. Particular attention needs to be given to:

- entities within the MNE group which are resident in jurisdictions with a tax rate of less than 15%;
- whether entities in the fund could form part of an investor's MNE group; and
- how Pillar Two either has been or will be in point for a potential investment acquisition or disposal.

02

BEFIT for a FASTER future: a review of the latest EU tax developments

Laura Charkin and Matthew Rees (Goodwin)

02 BEFIT for a FASTER future: a review of the latest EU tax developments

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2023 has been another interesting year for European Union tax initiatives. This article follows up on our previous item "Are you SAFE from DEBRA? Unpicking the latest EU tax initiatives" (BVCA Policy and Technical Bulletin, November 2022) and looks at recent changes in the EU tax landscape, how they might impact the private capital industry, and what developments could lie ahead.

The BVCA works collaboratively with Invest Europe to ensure that members' interests regarding EU tax policy are represented, and is grateful for Invest Europe's vital work with policymakers in Brussels.

UNSHELL/ATAD 3

In January 2023, the European Parliament adopted the proposed text of the ATAD 3 Directive, also referred to as the "Unshell Directive", being the third iteration of the EU's Anti-Tax Avoidance Directive. ATAD 3 is aimed at ensuring that EU "shell" entities (that is, entities with little or no commercial or economic activity) are denied the benefit of tax treaties within the EU and certain EU Directives, should they fail to meet or report on certain minimum "substance" indicators.

For European fund managers, the key question surrounding ATAD 3 has been the extent to which the proposal will impact EU holding structures through which limited partnership-based funds commonly invest. The answer to this question has been, and remains, unclear.

Importantly, the initial European Commission draft of the Directive included an exemption for "regulated financial undertakings" (which, broadly, covers vehicles established as AIFs and managed by AIFMs). While there remains concern in the funds industry that the exemption has not been expanded to cover the entities owned by such undertakings, there is also a sense of (cautious) relief that certain suggestions made during the committee stage to remove the exemption altogether have (for now) not been adopted, with the exemption surviving both the amendments of the Economic and Monetary Affairs Committee in December 2022 and the adoption of the proposed text by the European Parliament in January this year.

That said, the draft text (as adopted by the Parliament) requires the Commission to submit a report five years from the date of transposition, in which it must (amongst other things) assess whether the obligation to report on minimum substance indicators should be extended to regulated financial undertakings and, if necessary, for the Commission to undertake a complete review of the exemption.

There has been a general sense of uncertainty around ATAD 3 for some time now and this has been further intensified by recent political deadlock. The Council still needs to vote on whether to adopt the Parliament's proposal (which requires unanimity amongst all 27 Member States) and there is no guarantee that a consensus will be achieved any time soon. In June, the ECOFIN reported to the Council that, despite some progress, further compromises would need to be reached on outstanding points. While the Council's current Spanish presidency has committed itself to pushing through ATAD 3, any chances of the Directive taking effect in January 2024 (as originally intended) are, at the time of writing, increasingly slim.

ATAD 3 faces an uncertain future, and it remains to be seen when, and in what form, the proposed Directive would be adopted, or even if it will be adopted at all. As these doubts continue to linger, with speculation that ATAD 3 could ultimately be scrapped (at least in its current form), one concern is that an increasing number of Member States seem to be taking matters into their own hands.

This has long been the case for jurisdictions like Germany, for example, but the number of Member States which are adopting their own formal or informal approaches to policing access to EU Directives and double tax treaties is on the rise. This in itself is problematic, as the adoption of potentially differing substance requirements in an uncoordinated way creates uncertainty, and thereby makes it more difficult to manage tax risks and to structure investments effectively.

What is clear is that more certainty is needed, and the BVCA will continue to monitor developments to ensure the needs of the private capital industry are represented where the opportunity arises.

FASTER

Previously lacking an acronym when covered in our November 2022 Bulletin, the "Faster and Safer Relief of Excess Withholding Taxes" (FASTER) proposal is now picking up speed, with the European Commission proposing a draft Directive on 19 June 2023 and closing its feedback period on 18 September 2023.

During the consultation phase, certain legislative options were outlined for a faster, more streamlined process for EU-wide withholding tax reclaims: EU-wide standardised forms, a common EU system for relief at source, and a system for the automated and mandatory exchange of beneficial owner-related information.

The draft Directive reflects each of these, through the four key elements set out below. However, the current proposal is limited both in terms of the types of "financial intermediaries" which are mandatorily within scope and in its application to payments of dividends (or interest) from publicly traded shares (or publicly traded bonds). It is therefore expected to have minimal impact, at least at present, on the private capital industry in the short term, but is of interest in that it is indicative of the direction of travel, in terms of managing withholding taxes within the EU.

The elements are:

- A common EU digital certificate of tax residence (eTRC) containing standardised information, such as the identity and jurisdiction of residence of the taxpayer, and designed to enable the taxpayer to claim multiple refunds during the same calendar year. The eTRC would replace Member States' existing paper-based procedures, and in the interests of expediency, would need to be issued by Member States within one working day of a taxpayer's application.

- The engagement of "certified financial intermediaries" (CFIs) by applicant investors, whose role it would be to obtain and verify the beneficial ownership and tax residence of such investors. All financial intermediaries that are large institutions (as defined in the Capital Requirement Regulations (CRR)) and handle payments of interest and dividends must register with Member State authorities. Other financial intermediaries (as defined in the CRR, MiFID II and Central Securities Depositories Regulation) may choose to register. The definition of "financial intermediary" includes "investment firms" (which includes portfolio managers and advisor/arrangers) but not AIFMs.

- Standardised reporting obligations, requiring CFIs to report relevant interest and dividend payments to national tax authorities within 25 days, thereby allowing the authorities to trace the transactions, confirm entitlements to withholding tax relief and identify any abusive practices (such as those identified in the "Cum/Ex" schemes which had operated in certain Member States).

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- A requirement on Member States to adopt one or both of the "relief at source" procedure (whereby the tax rate under the appropriate double tax treaty is applied at the time the payment is made), and/or the "quick refund" procedure (whereby the tax is withheld at the higher rate, but with the excess repaid within 50 days of payment).

Any initiative designed to fast track and modernise withholding tax reclaims (while empowering efforts to tackle tax abuse) should be welcomed. However, as we highlighted last November, the proposal is founded on concepts (such as "residence" and "beneficial ownership") that are not always interpreted consistently by Member States, and the Directive's current text does not address these concerns. Intermediaries responsible for verifying information as regards residence and beneficial ownership will find it particularly difficult to do so, in the absence of any EU-wide consensus as to the correct interpretation of these concepts. There is therefore likely to be a significant compliance burden for in-scope CFIs, who it is proposed will be held liable for lost withholding tax should they fail to comply with their obligations under the Directive.

As noted above, the expected implications for the private capital industry in the short term are limited, given the current focus of the draft Directive on listed securities. However, if FASTER is expanded in scope at a future date, further engagement will be needed in order to allow the regime to function as intended in the context of private capital funds.

BEFIT

Another EU tax initiative mentioned in our November 2022 Bulletin was BEFIT ("Business in Europe: Framework for Income Taxation"), which at the time was subject to a public consultation exercise. The initiative is now starting to shape up in earnest, with the European Commission proposing a first draft of the BEFIT Directive on 12 September 2023, which, if adopted by the Council, is expected to be transposed by 1 January 2028 (and to come into force on 1 July 2028).

BEFIT proposes a common tax base across the EU and allocation of profits between Member States based on a formula broadly reflective of Pillar 2. Under the draft BEFIT Directive, the rules will apply on a mandatory basis to (a) groups headquartered in the EU and having an annual combined revenue of at least €750m, and (b) groups headquartered outside the EU, but whose EU members raise an annual combined revenue of €50m in two of the last four fiscal years or account for at least 5% of the group's revenue. A BEFIT group comprises the parent entity and any subsidiaries in which it holds directly or indirectly at least 75% of the ownership rights or rights giving entitlement to profit. Groups not meeting the relevant thresholds may opt-in to BEFIT if they prepare consolidated financial statements.

The starting point in determining the common tax base of the BEFIT group is to aggregate each group member's consolidated financial accounts, reconciled as needed with the accounting standards adopted by the ultimate parent entity, and subject to certain common tax adjustments (including in relation to deductible costs, tax depreciations, and income and losses attributable to permanent establishments, amongst others). The aggregated tax base is then allocated between each group member, according to their weighted share of the total tax base in the previous three fiscal years.

This "transitional allocation rule" will apply in the first seven fiscal years following implementation, after which the Commission may adopt, on a permanent basis, an allocation method that is based on formulae and potentially designed using data gathered from the first years of the application of BEFIT. Once allocated, Member States may apply further deductions, tax incentives or base increases to their allocated part (provided they do so in compliance with Pillar 2).

The draft Directive also includes a new transfer pricing "traffic light" system for certain distribution and manufacturing activities, whereby Member States will be required to categorise risk assessments into low, medium and high zones, by comparing profit performance against EU-wide public benchmarks.

Additionally, no withholding tax on interest and royalties would be applied within a BEFIT group (provided the beneficial owner is a BEFIT group member), and for compliance and administrative ease, the new rules would also allow one group member to file the group's information returns with the tax administration of a single Member State.

Previous proposals of a similar nature have floundered in part due to difficulties with the allocation formula, and it is notable that, this time, the Commission has given itself some breathing room with a transitional rule. Further, as with Pillar 2, although many funds and fund management groups will be excluded from the mandatory scope of BEFIT due to the €750m threshold (or the €50m and 5% thresholds for third country headquartered groups), it is possible that some portfolio investments could be caught depending on the fund structures used and accounting policies adopted.

SAFE

While FASTER and BEFIT gain momentum, the initiative known as SAFE ("Securing the Activity Framework of Enablers") is apparently proving more difficult to crack.

The SAFE proposal, which was subject to a public consultation from June to October 2022, sets out three options designed to secure that "enablers" are prohibited from assisting in arrangements of schemes that lead to "tax evasion" or "aggressive tax planning" in EU Member States. How this last concept is ultimately defined will be of key interest.

We recommend reading our November 2022 article, where we covered the options being proposed and set out our views on the practicability of the initiative as a whole.

However, those looking forward to seeing the draft text of the Directive (including whether and how SAFE might impact tax professionals working "in house" at funds) will need to wait a little longer. While the Commission's intention to adopt the proposal in the first half of 2023 has proved over-ambitious, and no other developments of note have yet been published, there is still considerable momentum behind this proposed Directive.

The BVCA will continue to monitor developments on SAFE and its potential impact on the private capital industry.

EU list of non-cooperative jurisdictions

On 17 October 2023, the EU published its revised list of non-cooperative tax jurisdictions, with Antigua and Barbuda, Belize and Seychelles added, and Costa Rica, the Marshall Islands and the British Virgin Islands removed. The BVI, which was included in the list in February 2023 for alleged non-compliance with OECD standards on the exchange of information, has now been added instead to the EU's so-called "grey list" (a list of jurisdictions which have committed to implementing reforms but do not yet comply with all expected tax good governance standards).

The list of non-cooperative jurisdictions is updated biannually by the EU Council's Code of Conduct Group for Business Taxation (CoCG), and since its first publication in December 2017, has formed part of the EU's wider efforts in promoting tax good governance worldwide, with jurisdictions assessed for their commitment to tax transparency, fair taxation, and the implementation of international standards designed to prevent tax base erosion and profit shifting.

Inclusion on the list can have significant tax consequences, for instance payments to recipients resident for tax purposes in listed jurisdictions may trigger reporting requirements under DAC 6, and may be denied tax deductions that are otherwise available or subjected to higher rates of withholding tax by Member States adopting national "defensive measures" in accordance with the CoCG's agreed guidance. In addition, some investors (such as Danish pensions funds subscribing to the Tax Code of Conduct) have become concerned about the reputational impact of using an entity based in an affected jurisdiction.

As such, the list has proven to be influential in recent years, with, for example, the use of structures based in the Cayman Islands as vehicles to invest in the EU seeing a notable decrease following the jurisdiction's initial inclusion in the list in February 2020 (notwithstanding its removal 6 months later).

OECD Pillar two

Finally, as widely noted, Pillar two will begin to take effect in many countries from the start of 2024, including the UK and in the EU. For more information, see "*Update on OECD Pillar two*", published in this Bulletin.

03

AIFMD II: A new framework for loan origination activities

Stephanie Biggs (Simpson, Thacher and Bartlett)

03 AIFMD II: A new framework for loan origination activities

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The wait is over...

The AIFMD II package was finally agreed at the end of October 2023. In the end, it will be a relatively limited scope upgrade to the EU AIFMD – more AIFMD 1.1 than AIFMD 2.0.

The most notable change is the introduction of a dedicated regulatory framework for EU funds that engage in loan origination (direct lending) activities. In this article, we highlight the key elements of the new regime and, importantly, the implementation timeline. Transitional relief is relatively limited, so if you are currently raising an EU direct lending fund, this needs to be on your radar now.

Scope

The AIFMD II loan origination regime applies only to EU AIFMs managing funds that originate loans. It is not currently anticipated that there will be any UK equivalent to the EU loan origination framework.

There are two key scoping concepts:

- "Loan origination" or "originating a loan" means the granting of a loan directly by an AIF as the original lender (including through an SPV), where the AIFM or AIF is involved in structuring or defining the terms of the loan.
- A "loan-originating AIF" means an AIF:
  i. whose investment strategy is mainly to originate loans; or
  ii. where the notional value of the AIF's originated loans represents at least 50% of its net asset value.

Not all AIFs that originate loans will be "loan originating AIFs".

Certain core requirements apply to all AIFs that originate loans. Additional, more onerous, requirements apply to loan-originating AIFs.

Requirements applicable to all loan originating activities

Credit-granting policies and procedures: AIFMs must implement effective policies, procedures and processes for the granting of credit. Where they manage AIFs that engage in loan origination, including when they gain exposure to loans through third parties, they must also implement effective policies, procedures and processes for assessing the credit risk and for administering and monitoring their credit portfolio, keep those policies, procedures and processes up to date and effective and review them regularly and at least once a year.

Financial sector concentration limits: An AIFM must ensure that the notional value of loans originated by an AIF to any single borrower does not exceed in aggregate

20% of the capital of the AIF if the borrower is (broadly speaking) a bank, an insurer, a MiFID firm, an AIF, a UCITS or a financial sector holding company. This does not override the specific concentration limits applicable to ELTIFs or EuVECAs.

The AIF must be in compliance with the 20% financial sector concentration limit by the date specified in its constitutional or offering documents, which must be no later than 24 months from the date of the first subscription for interests in the fund and take into account the features and characteristics of the assets to be invested in. The regulator may approve a one year extension in exceptional circumstances on submission of a duly justified investment plan.

The concentration limit ceases to apply once the AIFM starts to sell assets to pay out investors as part of the liquidation of the AIF. Where the capital of the AIF is increased or reduced, the limit is temporarily suspended for so long as is strictly necessary to rebalance the portfolio, which must be no more than 12 months.

For purposes of calculating the concentration limit, the capital of the AIF is defined to mean "aggregate capital contributions and uncalled capital committed to the AIF, calculated on the basis of amounts investible after deduction of all fees, charges and expenses that are directly or indirectly borne by investors".

Connected party loans: Loans may not be granted by an AIF to: (i) the AIFM or its staff; (ii) the depositary or its delegates; (iii) any delegate of the AIFM or its staff; or (iv) any entity within the same corporate group as the AIFM (as defined under the EU Accounting Directive), unless that affiliate is itself a financial undertaking that exclusively finances borrowers not referenced in (i) – (iii).

Application of proceeds: Where an AIF originates loans, the proceeds of the loans, minus any allowable fees for the administration of the loans, must be attributed to that AIF in full. All costs and expenses linked to the administration of the loan shall be clearly disclosed to investors in accordance with Article 23 of AIFMD (see section 7.1 above).

Consumer lending: EU Member States may prohibit AIFs from engaging in consumer lending and/or servicing consumer loans in that Member State. Any such prohibition does not affect the AIFM's ability to market funds that engage in consumer lending activities within the EU.

Prohibition of "originate to distribute" strategies: AIFMs are prohibited from managing AIFs whose investment strategy, or part of whose investment strategy, is to originate loans with the sole purpose of transferring those loans or exposures to third parties.

Risk retention: AIFMs must ensure that the AIF retains 5% of the notional value of each loan it has originated and subsequently transferred to third parties. That percentage of each loan shall be retained: (i) until maturity for those loans whose maturity is up to eight years, or for loans granted to consumers regardless of their maturity; and (ii) for a period of at least eight years for other loans.

The risk retention requirement does not apply where: (i) the AIFM starts to sell assets of the AIF in order to pay out investors as part of the liquidation of the AIF; (ii) the disposal is necessary to comply with EU sanctions restrictions or with product requirements; (iii) the sale of the loan is necessary to enable the AIFM to implement the investment strategy of the AIF in the best interests of the AIF's investors; (iii) the sale of the loan is due to a deterioration in the risk associated with the loan and the purchaser is informed of that deterioration when buying the loan. The regulator can ask an AIFM to demonstrate that it meets the foregoing conditions.

Additional requirements for "loan-originating AIFs"

Leverage limits: Loan-originating AIFs are subject to the following leverage limits, calculated under the commitment method:

- 175% where the AIF is open-ended; and
- 300% where the AIF is closed-ended.

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The differential is intended to take account of the greater stability risks of open-ended funds, which can be subject to high redemptions.

Borrowing arrangements that are fully covered by contractual capital commitments from investors are not be considered to constitute exposure for the purposes of calculating that ratio. This has the effect, in particular, of excluding subscription lines from the leverage limit.

If a loan-originating AIF breaches its leverage limit for reasons beyond the AIFM's control, the AIFM must rectify the position within an appropriate timeframe, taking due account of the interests of investors.

As for all leveraged AIFs, regulators may impose stricter leverage limits where necessary to ensure the stability and integrity of the financial system.

Restrictions on open-ended fund structures: By default, a loan-originating AIF must be closed-ended. An open-ended structure may be used only if the AIFM can demonstrate, to the satisfaction of its regulator, that the AIF's liquidity risk management system is compatible with its investment strategy and redemption policy. This does not override any other requirements applicable to ELTIFs or EuVECAs.

Further detail on the liquidity management requirements with which an open-ended loan-originating AIF must comply will be set out by ESMA in RTS.

It should be noted that AIFMD II also extends the existing liquidity management requirements for all open-ended funds (not just loan-originating AIFs).

Funds that make shareholder loans

There are certain derogations for private equity funds whose only lending activities are the making of shareholder loans alongside equity investments in portfolio companies.

A "shareholder loan" is defined for these purposes to means a loan which is granted by an AIF to an undertaking in which it holds directly or indirectly at least 5% of the capital or voting rights, and which cannot be sold to third parties independently of the capital instruments held by the AIF in the same undertaking. Not all loans made by private equity or, in particular, venture capital firms will necessarily fulfil these criteria.

Specifically, the requirements for credit-granting policies and procedures set out in section 11.1(a) above and the leverage limits set out in section 11.2(a) above do not apply to an AIF whose lending activities consist solely of originating shareholder loans, provided that the notional value of those loans does not exceed in aggregate 150% of the capital of the AIF (as defined in section 11.1(b) above).

Timing

The AIFMD II revisions are expected to take effect at the beginning of 2026. The exact date is yet to be confirmed, as the implementation date will be two years from publication of the final legislative text in the Official Journal, but for planning purposes it would be reasonable to assume an effective date of 1/1/2026.

Transitional relief

There is only limited transitional relief. The transitional relief is assessed by reference to the date on which AIFMD II enters into force (the "In Force Date"). Note that the In Force Date is 20 days after the final legislative text is published in the Official Journal, so it will be a date in Q4 2023/Q1 2024, not the Q1 2026 implementation date. It would be reasonable to assume an In Force Date of 1/1/2024 for planning purposes, but this should be confirmed if relevant.

AIFs that do not raise capital after the In Force Date: AIFs that have been established before the In Force Date and do not raise additional capital after the In Force Date will be deemed to comply with the financial sector concentration limits, the leverage limits and the restrictions on open-ended fund structures in perpetuity, although the AIFM may opt in to these requirements by notice to the regulator.

Financial sector concentration limits and leverage limits: An AIF that is already established on the In Force Date will be deemed to comply with the financial sector concentration limits and leverage limits for 5 years from the In Force Date (so until Q1 2029), although the AIFM may opt in to these requirements by notice to the regulator. During the transitional period:

- if the AIF is in breach of the concentration limit, the AIFM may not increase the notional value of the relevant loan;
- if the AIF is in breach of the leverage limit, the AIFM may not increase the leverage of the AIF;
- if the AIF is below the limits, the AIFM may not increase that value or that leverage above the relevant limit.

Existing loans: Where an AIF has originated loans before the In Force Date, the AIFM may continue to manage such AIFs without complying with the requirements for credit-granting policies and procedures, connected party transactions, application of proceeds, prohibition of "originate to distribute" strategies or risk retention requirements with respect to those loans.

Regulatory

04

Retailisation: a continuing trend in private capital

Paul Ellison (Clifford Chance)

04 Retailisation: a continuing trend in private capital

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Increasingly retail investors are seeking out non-traditional investments for diversification and higher returns (especially when one compares the sustained level of overall outperformance of the private equity and venture capital (PE/VC) industry with public markets). This continuing trend of "retailisation" is an ongoing opportunity for both PE/VC fund managers to access new sources and pools of investment capital and to widen their investor base.

One way in which firms are looking to respond to this opportunity is by considering the use of one of several updated investment vehicles accessible to retail investors for future fundraises. Here we briefly summarise the UK's long term asset fund and the European long-term investment fund – vehicles that have been subject to recent reform.

The Long-Term Asset Fund (LTAF)

The LTAF is a vehicle for open-ended investment in illiquid long-term assets across various private capital strategies: venture capital, private equity, private debt, real estate and infrastructure. As such, LTAFs "can provide a useful alternative investment opportunity for consumers able to bear the risks of such investments". LTAFs are also directly regulated by the FCA, as distinct from other "alternative investment funds" or "AIFs", where the manager, but not the fund itself, is typically FCA regulated.

To date, LTAFs: (i) have largely been restricted to professional investors, certified and self-certified sophisticated investors, and certified high net worth individuals; (ii) have had limited pension exposure, restricted to defined benefit, and the default arrangement within qualifying defined contribution (DC) schemes; and (ii) been treated as Non-Mass Market Investments (NMMI).

On 29 June 2023, the FCA published Policy Statement (PS 23/7) setting out its responses to feedback received to its Consultation Paper (CP 22/14), proposing the broadening of retail and pension scheme distribution of the LTAF.

The FCA has confirmed in PS 23/7 that it will proceed with the final rules as consulted in CP 22/14 to recategorise a unit in a LTAF as a Restricted Mass Market Investment (RMMI) rather than an NMMI. The rationale for this is stated as being that although LTAFs are high risk products, with the benefit of investor protection rules under the RMMI regime, LTAFs should be accessible to retail investors so long as they understand the risks involved. Such investor protections include, among others, prescribed risk warnings and restricting the commitment retail investors can make in an LTAF.

This recategorisation means that LTAFs can be mass marketed and distributed to all retail investors, in addition to self-selected DC pension schemes and Self-Invested Personal Pensions, and that such investors and schemes can invest in an LTAF (with retail investors only being able to invest up to 10% of their investable assets (in aggregate to investments in other RMMI products)). This seemingly technical change is therefore significant to the retailisation agenda and the "democratisation" of private assets.

European Long-Term Investment Fund (ELTIF)

ELTIFs are the only type of EU fund dedicated to long-term investments (encompassing private equity, private debt, loans, infrastructure and real assets) that can be distributed on a cross-border basis within the EU to both professional, and soon more accessible to, retail investors. ELTIFs are also AIFs that are marketed as ELTIFs and are directly regulated by its national competent authority. The ELTIF regulatory framework sets out detailed fund rules on eligible assets and investments, diversification and portfolio composition, leverage limits and marketing.

Historically, and since the adoption of the first ELTIF regulation in 2015 ("**ELTIF 1**"), only a relatively small number of ELTIFs have been launched due in part to significant constraints in the ELTIF distribution process (demand-side) and stringent rules on portfolio composition (supply-side). Recognising the need to overcome these demand-side and supply-side limitations to make ELTIFs more attractive and easier to invest in, on 15 February 2023, the European Parliament adopted the amending regulation to the ELTIF1 ("**ELTIF2**").

ELTIF2's amendments, which comes into force on 10 January 2024, should therefore have the potential to unlock untapped potential to mobilise capital for the financing of long-term projects while ensuring strong investor protection for both professional and retail investors.

Two of the key amendments ELTIF2 makes in furtherance of the EU's retailisation agenda are to no longer require: (1) ELTIF managers or distributors to have to provide investment advice when marketing ELITFs to retail investors; and (2) retail investors to be subject to any initial minimum investment or limitation on aggregate investments.

What these changes mean for PE/VC managers are the ability to avoid having to provide any form of investment advice to potential investors, a service PE/VC managers do not typically offer to prospects in the context of other types of investment funds, and also to admit prospects who could not meet the existing initial minimum investment threshold of EUR 10,000. These changes, coupled with those to the scope of eligible assets, fund structures, and applicable thresholds, facilitate the EU's retailisation agenda and also help to ensure that ELTIFs are attractive to professional investors and fund managers.

For completeness, it should be noted that while the UK 'onshored' the ELTIF Regulation when the UK withdrew from the EU, because of the continued absence of establishment of UK ELTIFs, and the creation of the LTAF regime, the UK government announced in 2022 that it intends to repeal the ELTIF Regulation.

Seizing the opportunity

While retailisation is not a new concept, the strong demand for alternative and diversified investments with higher returns has meant that retail access to such investments is currently a particular area of focus for many market participants. In addition, the revised LTAF and ELTIF mean that retail access to these investments is more possible than ever before, sitting alongside existing popular channels such as the use of Part II UCI vehicles in Luxembourg.

PE/VC fund managers seeking to seize the opportunity of accessing new sources and pools of investment capital and to widen their investor base will be aware that targeting retail investors will come with additional compliance requirements. For example, in the case of the LTAF, PE/VC fund managers need to comply with the FCA's updated retail distribution and COLL rules, which among others include requirements to provide risk warnings and summaries. Likewise, in the case of ELTIFs, PE/VC fund manager need also prepare and provide obligatory risk warnings and seek explicit investor consent requirements under certain circumstances.

05

CSRD's impact on private capital

Patricia Volhard and John Young (Debevoise & Plimpton)

05 CSRD's impact on private capital

The EU's Corporate Sustainability Reporting Directive ("CSRD") requires companies to include a large body of sustainability information in their annual reporting, in accordance with the detailed European Sustainability Reporting Standards ("ESRS"). Many companies currently report information on a voluntary basis on their environmental and social impacts, such as their carbon emissions and data on their workforce, through, for instance, adhering to voluntary reporting standards and responding to ad hoc questions. CSRD requires companies to report publicly a significant amount of data in standardised form, and requires companies to arrange for external "assurance" of the information. CSRD takes a so called "double materiality approach". This means that reporting includes not only reporting on the impact of the company's activities on its own operations and business but also on the environment and society.

From 2025, large private EU companies will be in scope of CSRD. We outline in this article CSRD's impact on private capital.

Application of CSRD to portfolio companies

Sponsors should identify those portfolio companies which will be in scope of CSRD. In terms of its application to unlisted companies, CSRD applies to all "large" EU undertakings which exceed at least two of the following criteria:

- more than 250 employees;
- net turnover of more than €40 million; or
- balance sheet total of €20 million.

"Undertakings" comprise all the types of companies and partnerships listed in Annexes I and II of the EU Accounting Directive. Note that the EU Commission recently published a proposal to increase the financial thresholds to €50 million (turnover) and €30 million (balance sheet).

If the EU undertaking is a parent company, the criteria are assessed by reference to the parent and its EU and non-EU subsidiaries in aggregate. In terms of scope, sponsors should also check whether any portfolio company in or outside the EU has listed any equity or debt on any EU "regulated market", noting that CSRD first takes effect for financial years beginning on or after 1 January 2024 for large companies with securities listed on an EU regulated market which exceed on the balance sheet date the average number of 500 employees during the financial year.

From 2028, CSRD's scope broadens for EU companies headed by non-EU parent companies to encompass the worldwide group, subject to the group as a whole generating at least €150 million of turnover in the EU. These reports will follow separate and presumably simplified reporting standards, which are currently under development and to be adopted by the European Commission in 2024.

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05 CSRD's impact on private capital

For a group in scope, CSRD will either apply to the whole group, if headed by an EU parent, or otherwise particular EU entities (or an EU sub-group or sub-groups) within the group.

Application of CSRD to private equity funds

As a rule, CSRD applies to the same types of "undertaking" that are in scope of the EU Accounting Directive. However, by cross-reference to the EU Sustainable Finance Disclosure Regulation (the "**SFDR**"), CSRD exempts from its scope alternative investment funds and UCITS schemes, because, as a policy matter, the EU regards funds as primarily subject to the SFDR in terms of sustainability reporting. Note that CSRD does not exempt from its scope other types of investment vehicles managed by private fund managers, such as "non-AIF" segregated accounts, co-investment schemes and special purpose vehicles, and other entities established as holding companies, that in each case might qualify as a type of undertaking in scope. We discuss this further below.

Application of CSRD to private equity sponsors

Private equity sponsors will need to determine whether any EU entity in their own management or advisory group is in scope of CSRD. The entities in scope may comprise the whole group (if headed by an EU parent company) or particular EU entities or sub-groups within the larger group. Sponsors with, for instance, as EU alternative investment fund manager, may well be in scope, if the entity exceeds both the turnover and balance sheet thresholds.

Firms in scope are required to assess the "materiality" of the various reporting topics (and sub-topics) in the reporting standards, to filter out reporting areas that they do not consider to be relevant to their operations. The ESRS are divided into general and topical standards. Private equity firms will report on the general disclosures (which cover matters such as strategy, governance and risk management), which are always considered material. Each of the standards requires extensive reporting of matters such as relevant policies, actions planned to address harms and of extensive data. Private equity sponsors, in common with other financial services providers, have typically limited environmental footprints and may conclude that they can omit at least some of the environmental topical standards, such as those covering pollution and impact on biodiversity from their activities. However, most firms will likely report on the climate change standards, reporting on the energy consumption and greenhouse gas emissions of their own businesses.

A key outstanding question under CSRD is the extent to which it applies to a firm's investment activities. CSRD requires companies to report on the social and environmental impacts of their own operations and their value chain. "Value chain" is broadly defined as the range of activities, resources and relationships related to the company's business model and the external environment in which it operates – the activities, resources and relationships the company uses and relies onto create its products or services from conception to delivery, consumption and end-of-life. It encompasses "upstream" entities (sources of materials and service - suppliers) and "downstream" entities (distributors and customers) that the company depends upon for its business model. Companies report on value chain information where specified in the reporting standard, and should expect requests for information from companies which form part of their value chain.

How should private equity sponsors approach reporting on their value chain? As a rule, companies will likely concentrate on reporting under CSRD on the value chains that the company is most dependent on (representing the biggest risks for the company) and those in social or environmental "hot spots" (representing the biggest impacts for the company). In terms of its "upstream" value chain, a private equity sponsor will be dependent only to a limited degree on other entities to supply products or parts, but it may be dependent on other entities to supply services – such as a service company within its group, or a group or external entity acting as its delegated portfolio manager or sub-adviser. In terms of its "downstream" value chain, fund sponsors will need to consider both its distributors and customers. In private equity terms, distributors may cover the types of sales intermediaries that many sponsors appoint to distribute their product, and customers covers their funds and other types of clients, including segregated account holders, and conceivably other financial services providers to whom the firm provides services, such as an offshore fund manager.

All financial services providers face challenges in applying the value chain reporting concept to their operations. EFRAG, which provides technical advice to the Commission on financial reporting, published in August 2023 draft guidance on the value chain concept, but did not provide any guidance as to how financial services firms should report on value chains. In a document EFRAG published in February 2023, "Financial institutions – ESRS Sector process", EFRAG made it clear that, given the "peculiarities" of financial institutions' relationships with clients, there is a need for guidance on the boundaries of their value chain reporting under CSRD, and indicated that the topic would be covered in the financial institutions sector specific standards.

Applying the general principle of value chain reporting, a lender which is active in financing the energy market and in scope of CSRD may disclose in relation to the environmental impacts of its borrowers. By the same token, a private equity sponsor actively investing in the developing world may consider it appropriate to disclose in relation to the social impacts of its investment activities. However, that will substantially broaden the information the sponsor reports, and tends to run contrary to the principle that funds themselves are out of scope of CSRD. The application of sustainability reporting to the financial services sector will remain unclear until the sector specific reporting standards are published. Given EFRAG's prioritisation of sector specific standards for industries with high environmental and social impacts (such as mining and agriculture) and the Commission's recent proposal to delay the adoption of the sector specific reporting standards until June 2026, we do not expect to see draft financial services sector standards in the short term.

Otherwise, in the finalised climate change reporting standard, there is guidance for "financial institutions", when reporting on Scope 3 GHG emissions, to consider the GHG Accounting and Reporting Standard for the Financial Industry, specifically Part A Financed Emissions and Insurance-Associated Emissions. Many asset managers will be familiar with the concept of "financed emissions", which covers GHG emissions attributed to the investments made by the manager, and will already be reporting, to some degree, on the emissions in their portfolios of assets under management. Many managers report voluntarily on climate related matters under the Taskforce on Climate Related Financial Disclosures, which includes recommendations on reporting on, for instance, how climate change is integrated into investment process and the manager's engagement policy with investee companies on climate change, as well as GHG emissions for their assets under management, where data and methodologies allow.

Lastly, the EFRAG February 2023 paper notes that the forthcoming Corporate Sustainability Due Diligence Directive ("**CSDDD**") "will be a relevant point of reference for sector specific guidance for financial institutions and appropriate consideration in the timeline and approach should be given on how to ensure compatibility". This indicates that the scope of value chain reporting for investment managers under CSRD will not be more extensive than the degree of responsibility that such managers must take for the social and environmental impacts in their value chains under CSDDD. That point is currently under debate by the EU institutions.

Application of CSRD to holding companies and co-investment schemes

Sponsors will also need to consider under CSRD the position of structures, such as holding companies for portfolio company groups and co-investment vehicles, which may be governed by nominated directors of the fund sponsor. The EU Accounting Directive sets out the current basis for consolidated financial reporting by groups. CSRD, by means of a series of additions to the Accounting Directive, introduces sustainability reporting on largely the same basis. In that regard, sponsors should expect that the scope of consolidated sustainability reporting will follow the scope of existing financial reporting for a given group, and that funds, holding companies and co-investment vehicles will be consolidated for sustainability reporting only where they are consolidated for financial reporting. In this regard, sponsors should understand the existing exemptions in the Accounting Directive for, for instance, consolidation where the shares of a subsidiary undertaking are held exclusively with a view to their subsequent re-sale, and exemptions for certain types of entities (such as the Luxembourg SCSp) from the existing scope of the Accounting Directive.

However, complications may arise. The scoping exercise under CSRD initially only applies to the EU companies (or EU parent companies) that sit within worldwide groups, whilst the scope of financial consolidation will generally comprise the worldwide group. Secondly, the sustainability reporting standards do not include the same exemptions for, for instance, consolidation between funds and portfolio companies that have been developed under financial reporting standards. The treatment of interests in "associates" (which are entities over which an investor has significant influence but not control) and joint ventures is also specifically addressed in certain of the sustainability reporting standards. For instance, the climate change standard requires a company to report on GHG emissions in a joint venture where the undertaking has "operational control" of the joint venture.

Links between CSRD and SFDR

One of CSRD's aims is to ensure that "financial market participants", which are bound by the SFDR sustainability disclosure regime, obtain the information they need from their investee companies, in particular those listed on EU regulated markets. All the "principal adverse impact" data under the Sustainable Finance Disclosure Regulation ("SFDR") is contained in the ESRS, with EFRAG supplying a mapping table for that purpose in the ESRS. However, all data in the ESRS is subject to the materiality filter. This would allow an investee company not to report on, for instance, GHG emissions, if it concludes that its emissions are not material. As companies must set their own thresholds to determine materiality, sponsors may find companies do not take "like-for-like" approaches in this respect.

Links between CSRD and EU Taxonomy Regulation

Sponsors should bear in mind that investee companies that are in scope of CSRD will also report on information on their activities and the EU Taxonomy Regulation. This will broadly comprise reporting on the proportion of their activities (by turnover) that are Taxonomy "eligible" (in scope of the Taxonomy) and are aligned with the Taxonomy technical screening criteria. Companies listed on EU regulated markets are already subject to this obligation. Private fund sponsors may already be collecting this information from their investee companies, usually on the basis of a process built in collaboration with the company. When investee companies fall in scope of Taxonomy reporting under CSRD, that will relieve the private equity sponsor from expending its own time and resources on collecting Taxonomy related information from the company. However, companies processes for Taxonomy reporting, and the figures they report on their degree of alignment, may well change as a result of the CSRD assurance process.

06

BVCA Accounting, Reporting & Governance Committee: Introduction to the new committee and what it will cover

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06 BVCA Accounting, Reporting & Governance Committee: Introduction to the new committee and what it will cover

Introduction

On 19 September 2023, the BVCA Accounting, Reporting & Governance (ARG) Committee came together for the first time. What followed was a fruitful conversation on key topics for the private capital industry and advice on how the BVCA should respond.

The BVCA established the new Committee, which was for the last number of years part of the Legal & Accounting Committee, to give more focus on the issues around corporate reporting, sustainability and good governance. This reflects the growing legislative and regulatory output from governments across the world, and the need for the BVCA to bring members together to address this output.

The ARG Committee comprises lawyers, chief financial officers, finance directors, senior compliance personnel and accounting professionals from the Big 4 and challenger firms. Jonathan Martin, Partner and Head of Asset Management Audit at KPMG, and Karen Sands, COO of Federated Hermes Global Private Equity, are Chair and Vice Chair of the Committee, and will lead the strong group of members and advisors to respond to the policy needs of the industry.

Key activities of all technical committees at the BVCA can be summarised as:

- Responding to consultations from regulators and government departments.
- Raising awareness and sharing knowledge on best practices.
- Responding to emerging trends and topics.
- Engagement with working groups, other committees and members of the BVCA.

The Committee has hit the ground running, having met the Financial Reporting Council (FRC), written responses to both the UK Sustainability Disclosure Technical Advisory Committee (TAC) on UK Sustainability Disclosure Standards (SDS) and the FRC consultation on its Ethical Standard. It has discussed new EU reporting frameworks (CSRD, CS3D) and an industry response, assisted the BVCA in updating its Technical Reporting Guide, and contacted the Department for Business & Trade to discuss the expansion of the definition of a Public Interest Entity (PIE) and additional reporting requirements for large private companies.

Set out below is a brief view of two major policy files and what the Committee has discussed on each.

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What's on the Committee agenda

1. UK SDS (IFRS S1 & S2)

Key points

The UK Sustainability Disclosure TAC published a Call for Evidence to inform the proposed endorsement of the IFRS Sustainability Disclosure Standards in the UK (UK SDS).

This Call for Evidence looked into whether the Sustainability Disclosure Standards, in the context of the UK:

- will result in disclosures that are understandable, relevant, reliable and comparable for investors;
- are technically feasible to prepare;
- can be prepared on a timely basis and at the same time as general purpose financial reports; and
- are expected to generate benefits that are proportionate to the costs that are likely to be incurred.

Background

The International Sustainability Standards Board (ISSB) published its first two IFRS Sustainability Disclosure Standards earlier this year:

1) IFRS S1: General Requirements for Disclosure of Sustainability-related Financial Information. This is designed to report on sustainability-related risks and opportunities faced over the short, medium, and long term.
2) IFRS S2: Climate-related Disclosures. This sets out specific climate-related disclosures and is designed to be used in conjunction with IFRS S1.

IFRS S1 and S2 provide, for the first time, a global reporting standard for corporate sustainability disclosures. The objective is to improve the quality of sustainability-related reporting, help investors compare information between companies, aid decision making, and support the efficient allocation of capital.

The standards are currently voluntary but are expected to be endorsed in many countries globally. In the UK, the Secretary of State for Business and Trade is expected to endorse the standards, to create the UK SDS by July 2024. The UK SDS will be based on the IFRS standards and "will only divert from the global baseline if absolutely necessary for UK specific matters". Two advisory groups have been set up to establish the UK SDS – the UK Sustainability Disclosure Policy and Implementation Committee (PIC) and the UK Sustainability Disclosure TAC.

The UK SDS is expected to form the 'backbone' of sustainability reporting in the UK and will be part of the UK Sustainability Disclosure Requirements (SDR). The UK SDR also includes a UK Green Taxonomy and requirements for certain entities to disclose a climate transition plan. The FCA will be consulting on the standards and the Transition Plan Taskforce framework simultaneously, to explore the relationship between the two.

The IFRS S1 and S2 have built upon the Task Force on Climate-Related Financial Disclosures (TCFD) framework, with S2 being aligned with the TCFD recommendations. It has been suggested by the FCA that firms take early action and engage with the new IFRS S1 and S2 standards. This includes continuing to report in line with existing climate-related disclosures such as the TCFD, engage with the new standards and associated guidance, and engage with the UK endorsement and implementation process. If companies are not affected by the standards from the date of implementation, they are likely to be in the value chains of those who are or -will be impacted in future.

Anticipated industry impact – the BVCA response

The BVCA responded to the UK TAC call for evidence, first outlining the industry's support for a global baseline for sustainability disclosure. The private capital industry is international, investing and operating across borders. Convergence

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around the disclosure language will enable consistent and comparable reporting across businesses, which in turn should support the functioning of capital markets internationally. We support the priority work on climate and have been engaging on a range of sustainability topics with government departments as well as regulators both here in the UK and in the EU.

The response then focused on:

- ***Alignment with global standards***
  There is a need for global co-operation and co-ordination between different jurisdictions are essential for this to work effectively and reduce impact and costs. Many private capital firms have asset management and advisory entities, funds and portfolio companies in different jurisdictions and will have to comply with regulation and reporting standards in the UK, EU and US.

- ***Impact on the industry (referencing private capital structure)***
  Private capital firms, their investors and portfolio companies will be impacted by the implementation of the UK SDS. The data gathering, the processes involved, and the resulting reporting will require significant resource, resulting in substantial costs and additional assistance from external advisors, many of whom may not have the increased expertise and bandwidth to provide such services. The introduction of IFRS S1, S2 and future sustainability standards will require companies and asset managers to invest further to evolve their investment and reporting processes and will entail significant costs.

- ***Assurance on sustainability reporting***~
  Additional assurance will be required, and many private capital firms are starting to explore assurance for sustainability reporting, for example on TCFD. Accounting firms and other professional services providers and specialists, are not yet sufficiently resourced or indeed skilled to complete this difficult additional work. Auditor independence exacerbates this issue as there is less choice of service provider for many of the larger private capital firms and portfolio companies. The skills will need to be developed which will take time, and in the interim, the related costs will be higher than many anticipate.

- ***Scope and phasing in of requirements***
  Costs are always higher in the first year of implementing any new standard as external advisors, auditors and preparers of financial statements familiarise themselves with requirements and expectations of users of the accounts (including suppliers and customers) and upskill their staff. Given the subjective, forward-looking and qualitative nature of some of the disclosures, costs associated with assurance or verification of disclosures and judgements made will also be high. We recommended significant phasing in of the requirements and, in particular, the more difficult requirements where methodologies are still being developed.

  The scope is currently unknown, and it will be important to understand the views of the FRC/government on the thresholds that will bring an entity into scope. It will be equally important to understand who the standards will apply to and when, as well as the phasing in periods for each type of entity. Phasing should adopt recognised pre-existing criteria/categorisation (e.g., phased implementation of TCFD) and should happen over a number of years, starting with the largest quoted companies and moving down to those SMEs who meet a minimum set of pre-defined criteria. We also recommended that the "climate first" transition option, which allows an entity to provide only climate related disclosures in its first year, is included in the UK SDS. Additionally, due to difficulties which can be experienced when collecting Scope 3 emission data (due to the indirect nature of emission to an organisation) we recommended that further consideration is given to how materiality is factored into the implementation of UK SDS and how this can be phased for each organisation once within scope, to ensure data sets which are disclosed are as representative of an organisation's operation as possible.

We await a response from the TAC, and will continue to engage in the coming months. The Call for Evidence is the first step in the creation of the UK SDS. We expect further consultation as the proposals are developed further.

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2. FRC Ethical Standard revisions

Key points

The FRC consultation on proposed revisions to the Ethical Standard looks to bolster the principles surrounding the objectivity and independence of auditors, including removing the definition Other Entities of Public Interest (OEPIs) from the Standard.

Background

In 2019 and early 2020, the BVCA engaged with the FRC on the then revised Ethical Standard, which limits the provision of non-audit services by audit firms to their audit clients that are classified as PIEs or OEPIs. The standard became effective for PIEs for accounting periods commencing on or after 15 March 2020, and for OEPIs for periods commencing on or after 15 December 2020.

The proposed revisions to the Ethical Standards are, in the FRC's words, intended to "further enhance and clarify the principles of integrity, objectivity and independence that auditors must abide by". In addition to the withdrawal of the OEPI category, the consultation also covers the following areas:

- Breach reporting by audit firms to the FRC.
- Personal Financial Independence.
- Partner and staff rotation.
- Enhance prohibitions where an audit firm's independence could be threatened by an over-reliance on fees.

The BVCA focus was on the removal of OEPI definition, for reasons set out in the next section.

Industry impact – the BVCA response

We have always been supportive of, and involved in, government initiatives on corporate governance reform, corporate reporting and the consideration of different stakeholders (including employees and pensioners), and work by the FRC on the Ethical Standard (i.e., the provision of non-audit services). Through our work on the Wates Principles for corporate governance and the Walker Guidelines on transparency, large UK private equity-backed companies currently provide significant levels of disclosure. Indeed, in many of these areas, private equity-backed companies are leaders, with a sharp focus on effective governance and responsible stewardship. Companies covered by the Walker Guidelines already comply with some of the requirements currently applicable to PIEs.

The response focused on:

- ***BVCA position***
  The BVCA understands and agrees with the argument for removing the OEPI definition. Understanding which entities fell within its scope proved challenging since its introduction in 2019, particularly with cross references to other legislation. Additionally, the FRC recently issued a Call for Evidence on Non-Financial Reporting in the UK and more significantly, the government is expanding the PIE definition. Officials and the FRC will want as much consistency as possible with thresholds across financial and non-financial reporting. However, we think that if both proposals are brought forward, the Ethical Standard implementation guidance for private capital will cease to exist and the expanded PIE definition will bring into scope large UK portfolio companies owned by our members. This would have a detrimental effect on the provision of audit and non-audit services for our members and their portfolio companies.

  The existing implementation guidance for private capital funds was included by the FRC in November 2020, following discussions with the BVCA and members. It is important to emphasise that the guidance does not seek to limit the application of Ethical Standard paragraph 5.40 to services provided to the UK parent and the OEPI itself. It does however, allow the OEPI auditor to provide other services to the UK parent in respect of its other portfolio companies or non OEPI investments. If the PE implementation guidance ceases to exist then the unintended consequences on the rest of the funds/ portfolio companies becomes the major concern for the private capital industry.

- ***Structure of private capital***
  The structure of private capital funds, and the way in which firms invest in and manage businesses, is very different to a typical corporate group. However, the Ethical Standard still applies because private capital funds will typically have controlling stakes in the portfolio companies in which they invest. Portfolio companies are acquired and sold by the fund more frequently than in a corporate group which adds to the complexity of managing independence conflicts as many audit firms will be used. In turn this means that there can be unintended consequences such as delays to a transaction timetable to address independence requirements, even where the threats to auditor independence are limited or non-existent. Private capital firms can therefore be at a disadvantage to corporate groups in an M&A process as it is more difficult for them to impose a change of audit firm or prevent a portfolio company from using an audit firm.

  In contrast to a corporate group which, more often than not, will use one firm for the audit of all its group companies, private capital structures (i.e., the manager, fund(s) and its portfolio companies) do not operate in the same way. In particular, many private capital firms do not see it as their role to intervene in portfolio company management's decision as to which firm is engaged as auditors. Hence, it will often be the case that many different firms audit different portfolio companies. The consequence of this being to limit choice in the market.

- ***Practical impact of changes***
  The expansion of the PIE definition and revision of the Ethical Standard will have a detrimental effect on choice in the audit and non-audit services market. The expansion of the PIE definition will bring into scope many large portfolio companies, who may have several different audit firms providing services while the removal of the OEPI category of entities in the Ethical Standard will remove the adaptation we sought in 2019/2020.

  The importance of retaining the PE implementation guidance is such that it would ensure the Ethical Standard is applied fully to the fund in relation to any PIE portfolio companies that it holds and their auditor, however, the fund would be able to engage that audit firm to provide services in respect of any portfolio companies within the fund where the service is not relevant to, or in respect of the audited PIE portfolio company. Otherwise, the portfolio companies and the private capital firms will potentially be restricted in using any of these audit firms for services that it itself is looking to procure (even for the provision of services in relation to an unrelated portfolio company which itself is not a PIE). This restriction on choice is a significant issue as it conflicts with another fundamental point for a private capital firm, being their obligation (both contractually under the fund documentation and as a fiduciary acting in the best interests of its investors) to seek support and advice from the most relevant and appropriately experienced advisors. This advice includes due diligence and structuring services. The adaptation ensured that the new restrictions on auditors did not taint the entities in a fund structure, including other (non-related) portfolio companies, and the fund manager.

- ***BVCA key recommendations***

  1. Primary Legislation regarding PIE definition
  The question of maintaining the PE implementation guidance in the event of the removal of the OEPI definition, may be best delayed and addressed at the point that the government publishes primary legislation to expand the PIE definition. This legislation has been delayed on many occasions and we do not know when it will be presented to Parliament. The Labour Party has promised to follow through

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on the reforms, following numerous delays by the current government.

We have asked that the FRC take the opportunity to engage with the government with regard to the importance of the PE implementation guidance, such that it can be introduced into primary legislation. This would allow alignment between the FRC Ethical Standard and primary legislation relating to PIEs. It remains to be seen whether they are willing or able to do this.

2. Ethical Standard

The PE implementation guidance that is currently included in the November 2020 document should be preserved as a first preference, after removal of the OEPI definition. It needs to be included in guidance relating to the new PIE definition and its interpretation.

In the event that primary legislation cannot be changed to incorporate the PE guidance into the definition of a PIE and its UK parent, it will be important to ensure that regulation reflects the specificities of a typical private capital structures and does not treat it the same way as a conglomerate or large corporate group.

The BVCA requested that the FRC explore ways to introduce a set of principles that apply in PE house fund situations within the Ethical Standard (essentially re-instating the PE implementation guidance for the new PIE definition, once the OEPI definition is removed). This might include a consideration of:

a) how the rules in para 5.40 apply to situations where a UK parent fund seeks advice in relation to unconnected portfolio companies. Is there a way to limit the application of the para 5.40 restrictions in PE situations, such that the services to a UK parent are prohibited where they are in respect of the PIE portfolio company but explain how the rules apply to situations where the UK parent seeks advice in relation to an unconnected portfolio company.

b) Could 5.40 be amended such that a fund is not a "UK parent" as it does not exert the same level of management influence as a corporate group situation. By introducing the PE implementation guidance in this section, this will mean that choice for unconnected portfolio companies in the same fund would not be restricted (subject to threats and safeguards), but services in connection with the PIE portfolio company would have to comply with ES.

Once again, we await a response from the FRC and government, and will continue to engage in the coming months.

Legal

07

SEC Private Fund Adviser Rules

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07 SEC Private Fund Adviser Rules

Introduction

On 23 August 2023, the US Securities and Exchange Commission ("**SEC**") adopted new and amended rules under the Investment Advisers Act 1940. There are five main elements of the rules: (i) the Preferential Treatment Rule; (ii) the Restricted Activities Rule; (iii) the Quarterly Statements Rule; (iv) the Audit Rule; and (v) the Adviser-Led Secondaries Rule (together referred to as the "**Private Fund Adviser Rules**").

The SEC first proposed new rules relating to "private funds" (which is broadly defined and covers private equity and venture capital funds, as well as hedge funds) in February 2022.[1] The Private Fund Adviser Rules, which were issued following a lengthy consultation process to which the BVCA responded, differ from the initial proposals in several important respects.

Whilst the impact of the Private Fund Adviser Rules on BVCA members will vary depending on several factors, including: (i) their SEC registration status; (ii) the jurisdiction in which the private funds they manage are based; and (iii) the involvement of any US sub-advisors, the Private Fund Adviser Rules represent the most substantive change in the regulation of private fund managers by the US since Dodd-Frank (which required many managers, including non-US managers, to register with, and/or provide information to, the SEC for the first time).

Applicability

a) ***Non-Registered Investment Advisers:***

Non-US[2] Exempt Reporting Advisers ("**ERAs**")[3] and non-US advisers otherwise exempt from registration with the SEC are subject to the Preferential Treatment Rule and the Restricted Activities Rule, save as described below.

i) ***Non-US Clients***

The SEC stated in its publication of the final rules that: *"We proposed to continue to apply the Commission's historical position on the substantive provisions of the Advisers Act to the prohibited activities rule such that the rule would*

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[1] Under the Investment Advisers Act, "Private Funds" are funds that would be investment Companies under the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7). 3(c)(1) applies when a fund has fewer than 100 beneficial owners. 3(c)(7) applies when all investors in a fund are "qualified purchasers" (an investor that meets certain financial and sophistication standards).

[2] An adviser which has its "principal place of business" outside of the US.

[3] An exempt reporting adviser is not required to register with the SEC as an investment adviser under the Investment Advisers Act because it relies on one of the following exemptions: (i) the Private Fund Adviser Exemption (an adviser solely to private funds that have less than $150 million in assets under management in the United States); or (ii) the Venture Capital Adviser Exemption (an adviser solely to venture capital funds). While ERAs are not registered with the SEC, they are still subject to specific reporting requirements and certain other Investment Advisers Act and federal rules, and they also may be subject to state filing or registration requirements.

not apply with respect to a registered offshore adviser's non-U.S. private funds, regardless of whether those funds have U.S. investors". The SEC also noted that *"Several commenters supported applying the Commission's historical approach to all of the proposed rules"* (referring to the submissions of the BVCA and others).

The SEC concluded: *"We agree with commenters and clarify that the restricted activities rule and the preferential treatment rule do not apply to offshore unregistered advisers with respect to their offshore funds (regardless of whether the funds have U.S. investors" and that "This approach is also consistent with our historical position of not applying substantive provisions of the Advisers Act to SEC registered offshore advisers with respect to their offshore clients, including private fund clients."*

This is a welcome outcome for non-US managers managing non-US private funds, which applies even when US investors are invested in such funds.

A non-US manager should nevertheless ensure that any disclosure with respect to its Investment Advisers Act status (such as in offering materials) makes clear that the private fund and investors in the private fund do not receive the protections provided for in the Private Fund Adviser Rules.

A non-US manager also remains subject to the anti-fraud provisions of the Investment Advisers Act (Section 206 and Rule 206(4)-8) and US federal securities laws, and as such cannot engage in misleading communications or omit material facts in communications with private fund investors. The Private Fund Adviser Rules provide guidance on what the SEC views as potentially misleading to investors and managers should take this into consideration when preparing their offering materials. A manager must also continue to provide full and fair disclosure to investors and receive informed consent from investors to material conflicts of interest.

ii) *US Clients*

Non-US ERAs and advisers otherwise exempt from registration with the SEC are subject to the Preferential Treatment Rule and the Restricted Activities Rule in respect of their US clients. As such, a UK-based manager of a Delaware fund vehicle will need to consider the application of those rules. Whilst this is unlikely to be relevant on most UK managers' private equity fund structures, it is likely to be a significant issue for UK managers' hedge fund structures, given the prevalence of Delaware fund vehicles in traditional hedge fund structures

iii) *Sub-Advisors*

A RIA that serves as a Sub-Advisor to a private fund with a third-party manager may have obligations under each of the Private Fund Adviser Rules.

In relation to two of the rules, the SEC clarified the responsibilities of a Sub-Advisor: (i) under the Quarterly Statements Rules, a Sub-Advisor must prepare and distribute quarterly statements only if the main advisor does not do so; and (ii) under the Audit Rule a Sub-Advisory must take "*all reasonable steps*" to ensure that the fund undergoes and distributes audited financial statements.

The application of the Preferential Treatment Rule, Restricted Activities Rule and Adviser-Led Secondaries Rule to sub-advisors will depend on the facts and circumstances of the Sub-Advisor's role, if any, on activity covered by those rules.

The application of the Private Fund Adviser Rules to sub-advisory arrangements will therefore require careful analysis on a case-by-case basis.

b) ***Registered Investment Advisers ("RIAs")***

US RIAs are subject to all of the Private Fund Adviser Rules, regardless of the location of the fund vehicle.

Non-US RIAs are subject to the Private Fund Adviser Rules with respect to their US fund vehicles only. UK managers that have RIAs in their group structure will therefore need to consider carefully the application of all of the Private Fund Adviser Rules and whether as a policy matter they will apply them more broadly than strictly required (e.g., to non-US fund vehicles managed by the RIA).

Effectiveness

Subject to applicability as described above, for managers with $1.5 billion or more in private fund assets under management ("**AuM**"), the Preferential Treatment Rule, the Restricted Activities Rule and (in the case of RIAs only), the Adviser-Led Secondaries Rule become effective on 14 September 2024.

For managers with less than $1.5billion, the same rules become effective on 14 March 2025.

The Quarterly Statement Rule and Audit Rule becomes effective for all RIAs on 14 March 2025.

Court Challenge

Following the publication of the Private Fund Adviser Rules, a group of six trade associations filed a petition for review with the Fifth Circuit Court of Appeals challenging the SEC's statutory authority to adopt and enforce them. It is understood that the trade associations have requested (without objection from the SEC) that the court issue a ruling by 31 May 2024.

The impact of any court decision is of course uncertain and it would be prudent for members to assume that the Private Fund Adviser Rules will become effective as currently published on the dates outlined above in any event.

Preferential Treatment Rule

This rule restricts managers from providing: (i) preferential treatment terms to investors regarding redemptions from the private fund that the manager reasonably expects to have a material negative effect on other investors, unless the ability to redeem is required by applicable law or the manager offers such rights to all other investors; or (ii) preferential information regarding portfolio holdings or exposures to an investor in a private fund if the manager reasonably expects that providing the information would have a material, negative effect on other investors, unless such preferential information is offered to all investors.

In addition, managers are prohibited from providing preferential treatment to investors, unless: (i) material economic preferential terms[4] are disclosed in advance of an investor's investment in the private fund; and (ii) all other preferential terms are disclosed, with the timeframe for doing so depending on whether the fund is an "illiquid" fund or a "liquid" fund, with the SEC setting out criteria to distinguish between them. In the case of an illiquid fund, the disclosure of the other preferential terms must be made as soon as reasonably practicable after the fundraising period.[5] In the case of a liquid fund, disclosure must be made as soon as reasonably practicable after the investor's investment in the fund.

[4] The SEC states that "material economic terms" include, but are not limited to, "*the cost of investing, liquidity rights, fee breaks, and co-investment rights*".

[5] It is expected that market practice will align on what is considered "reasonably practicable" and that this is likely to be based in part on current timing for commencing the MFN election process following final close of a fund (e.g. within 30 days). The SEC also observed that: *"Whether a written notice is furnished "as soon as reasonably practicable" will depend on the facts and circumstances. While this standard imposes no specific time limit, we believe that it would generally be appropriate for advisers to distribute the notices within four weeks."*

This rule therefore has significant implications for what is disclosed to investors prior to and following their investment and may involve significant changes in current practices on side letter negotiations and MFN processes.

Restricted Activities Rule

This rule limits the ability of a manager to: (i) charge a private fund fees and expenses associated with an investigation of the adviser without disclosure and consent from fund investors;[6] (ii) charging or allocating the private fund regulatory, examination or compliance fees or expenses, unless such fees and expenses are disclosed to investors; (iii) reducing the amount of clawback by the amount of tax charged, unless the manager discloses the pre-tax and post-tax amount of clawback;[7] (iv) charging fees or expenses related to a portfolio investment on a non-pro rata basis when multiple funds and other clients have invested in the same portfolio investment; and (v) borrowing from a private fund without disclosure to, and consent from, investors.

This rule is likely to lead to enhanced disclosures by managers, such as in relation to expense allocation on broken deal-costs which involved more than one fund and/or co-investors potentially participating, where such costs are not allocated on a pro-rata basis to their anticipated participation. Managers will need to monitor for situations such as these in which allocations of expenses may be carried out on a basis other than pro-rata.

Quarterly Statement Rule

This rule requires RIAs to distribute a quarterly statement to investors in the private fund, within 45 days of the quarter-end date (90 days in the case of the Q4 end date). The statement must disclose: (i) fund-level information regarding performance; (ii) the cost of investing in the private fund; (iii) fees and expenses paid by the private fund; and (iv) certain compensation and other amounts paid to the manager.

This rule is likely to lead to a material amount of additional work in preparing quarterly statements, as it essentially raises the amount of required disclosure to a level which is: (i) likely to be greater than Managers' current quarterly reporting; and (ii) may or may not be consistent with additional reporting requirements that managers have already agreed with individual investors. Managers should consider undertaking a gap analysis to see if information which is currently available to them is sufficient to comply with the rule or if additional information also needs to be collected. Co-ordinating with fund administrators on content and process changes is also likely to be required.

There will also be additional complications for quarterly statements prepared by fund of funds,[8] or where the manager needs information from a third party to prepare them (e.g. from a sub-advisor).

Audit Rule

This rule requires RIAs to cause the private funds they advise to undergo an audit that meets the requirements of the audit provision in the Investment Advisers Act Custody Rule (rule 206(4)-2).

RIAs that currently comply with the Custody Rule by obtaining a surprise examination for any of their private funds will need to obtain an audit for those funds under the Audit Rule.

It is understood that many RIAs that already undergo an audit of their private funds are looking at the possibility of using a second audit firm to satisfy the Audit Rule, given the

[6] The SEC is also specifically prohibiting fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Investment Advisers Act or the rules promulgated thereunder from being charged to a private fund.

[7] This represents a significant improvement from the SEC's initial proposal which would have prohibited managers from reducing the amount of clawback by the amount of tax charged.

[8] The deadlines for delivery of quarterly statements by fund-of-funds are longer – within 75 days of the quarter end date (120 days the case of the Q4 end date).

independence requirements for the auditor under this rule. This is likely to be especially complicated for RIAs in groups that are subject to Sarbanes – Oxley.

Adviser-Led Secondaries Rule

An RIA conducting an "adviser-led secondary transaction" (being a transaction which involves offering existing investors in a private fund the option between selling their interests in the fund and/or rolling their interests into a new vehicle, such as a continuation fund) must comply with two conditions. Firstly, an opinion must be obtained from an independent opinion provider that the price being offered is fair or stating the value, or range of values, of the assets to be sold. Secondly, a summary of any material business relationships the RIA has with the opinion provider.

Whilst the provision of fairness / valuation opinions on these sorts of transactions is now fairly typical, in light of the rule there may be an increased investor expectation of receiving them, even on transactions where this is not required under the rule (e.g., where the manager is not an RIA).

Proposed Rules Not Included in Final Rules

The SEC did not adopt several aspects of the rules as initially proposed. In particular the SEC did not prohibit: (i) indemnification of a manager's negligence; or (ii) charging fees for services that have not been performed.

However, this was because, in the SEC's view: *"we are not adopting the prohibition on fees for unperformed services because we believe this activity generally already runs contrary to an adviser's obligations to its clients under the Federal fiduciary duty. We are also not adopting the indemnification prohibition that we proposed because much of the activity that it would have prohibited is already prohibited by the Federal fiduciary duty and antifraud provisions."*

It can therefore be expected that the SEC will continue to focus on these matters during examinations of private fund managers.

Existing Private Funds

The SEC has acknowledged that terms of existing private funds have already been negotiated and has therefore provided "legacy status" to certain agreements where application of the Preferential Treatment Rule and Restricted Activities Rule would require amendment to comply with those rules. Legacy status applies for a fund that: (i) commenced operations prior to the relevant effective date; and (ii) where the fund agreement was entered into prior to the effective date.

Conclusion

BVCA members will need to conduct an evaluation of the impact, if any, of the Private Fund Adviser Rules on them, in light of their current group and fund structures, and SEC status.

Whilst the Private Fund Adviser Rules may only have a limited impact on many members directly, for some members, especially those that: (i) have RIAs in their group structure; (ii) manage US fund vehicles; and/or (iii) have a relationship with a US sub-advisor, the impact will be significant.

For members that are RIAs, the impact of the rules is considerable and will require an evaluation of any changes that are needed to their current practices. The impact is likely to be more meaningful depending on the investment strategies operated by the manager and whether certain mechanics are currently used (e.g., offsetting of expenses against management fees).

For members that are Non-US ERAs or which do not currently report to the SEC, the

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rules will be an additional factor to take into account when deciding whether to increase their US presence, including potentially pursuing an SEC registration.

Even where the impact on members is limited, they may wish to consider if investors (both US and Non-US) may require reporting, disclosure and fund terms of the type required under the Private Fund Adviser Rules as a matter of practice, and if so whether they are prepared to accommodate this.

08

Case Law update

Jonny Myers and Katherine Ellis (Clifford Chance)

08 Case Law update

Court of Appeal upholds High Court decision that class consent is needed for conversion of shares

In *Dnanudge Limited v Venture Capital GP Limited (acting for and on behalf of Venture Capital LP Fund IV and Venture Capital MG1 LP Fund)* [2023] EWCA Civ 1142 the Court of Appeal dismissed an appeal by DnaNudge Limited (the "**Company**") against a judgement of the High Court that the conversion of preferred shares into ordinary shares amounted to a variation or abrogation of the class rights and was void because the conversion had not received the consent in writing of the holders of more than 75% in nominal value of the preferred shares as set out in the variation of rights Article in the Company's Articles of Association.

Facts

Ventura and Sumitomo Mitsui Trust Bank ("**SMTB**") participated in a Company funding round and became the only holders of Series A preferred shares which were given enhanced rights to certain distributions. The Articles of the Company provided that all Series A Shares would automatically convert into ordinary shares upon notice in writing from an Investor Majority. "Investor Majority" was defined as the holders of a majority of the ordinary shares and the Series A Shares in aggregate as if such shares constituted one class of share.

The Articles also contained a variation of rights Article stating that the special rights attached to any class of shares could only be varied or abrogated with the consent in writing of the holders of more than 75 per cent in nominal value of the issued shares of that class.

The Investor Majority (which did not include Ventura or SMTB) served a notice on the Company requiring the conversion of all the Series A Shares into ordinary shares. Ventura objected to this conversion arguing that it involved a variation or abrogation of the rights attaching to the Series A Shares and was accordingly invalid by reason of a failure to comply with the variation of rights Article. When this dispute was brought to the High Court it agreed.

In the alternative to this claim Ventura sought an order pursuant to s.633 of the Companies Act 2006 ("**CA 2006**"), which applies where the rights attaching to any class of shares are varied under s. 630 of CA 2006, disallowing the variation and cancelling the conversion on the grounds that it was unfairly prejudicial to Ventura and SMTB. The High Court disagreed on this point, it ruled that the conversion had been carried out in accordance with the Articles and therefore there was no basis to grant relief cancelling or setting aside the conversion under s.633.

Decision

The Court of Appeal disagreed with the High Court that the substantial share premium which Ventura and SMTB

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paid over and above the nominal amount of the Series A Shares was a payment "for the special rights attached to those shares, in preference to the inferior rights enjoyed by the numerically far greater number of [ordinary shares] in the Company" and the High Court was wrong to place any weight upon this in its judgment.

However, the Court of Appeal did agree with the High Court that given the enhanced distribution rights and the protection for those special rights conferred by the variation of rights Article, the Company's interpretation of the conversion Article would lead to an incoherent scheme and irrational results. In particular it would give an Investor Majority comprising only ordinary shareholders, an unrestricted power to deprive the holders of the Series A Shares of those special rights at any time chosen by the ordinary shareholders and give a corresponding benefit to the ordinary shareholders. The Court of Appeal decided that something had gone wrong with the drafting of the conversion Article.

The Court of Appeal ruled that the Articles' wording suggested a continuation of the existing shares on conversion and also agreed with the High Court as a matter of the ordinary use of language, that the term "abrogation" accurately described the effect of the process by which the special rights attaching to the Series A Shares ceased to apply when they became ordinary shares.

Accordingly, the Court of Appeal agreed with the High Court's finding that the conversion Article had to be read as subject to the protection of special class rights Article which took precedence, or a term must be implied to that effect, such that compliance with the special class rights Article was a pre-condition to conversion.

The Court of Appeal rejected arguments that reference in the conversion Article to an "automatic conversion" of preferred shares upon notice from an Investor Majority excluded the possibility that other conditions might need to be satisfied for conversion to occur.

The Court of Appeal did not express a view as to whether s.633 applied. But noted that assuming that s633 does apply, it does not give the court an entirely free discretion to determine whether a particular variation of rights was unfairly prejudicial. On the assumed hypothesis that the Company was correct as to the true meaning of the Articles, the ordinary shareholders and the Company were not acting unfairly when they simply gave effect to the agreed terms of the conversion Article.

ClientEarth's derivative action against the directors of Shell plc is dismissed by the High Court

In *ClientEarth v Shell Plc and others* [2023] EWHC 1897 (Ch) following ClientEarth having exercised its right to ask the High Court to reconsider its May decision (which was based on papers alone) at an oral hearing, the High Court confirmed its earlier decision to refuse permission for ClientEarth to continue a derivative claim under Part 11 CA 2006 brought against the directors of Shell plc for alleged breaches of duties in connection with Shell's climate change risk management strategy.

Whilst this type of claim is more common for English public companies it does highlight the importance for financial investors of contractual protections of the rights and obligations of the shareholders and directors of private companies.

Facts

The first High Court case decided on paper

In February 2023, ClientEarth filed a derivative claim against Shell's directors for failing to prepare for climate risks facing Shell. ClientEarth alleged that Shell's directors breached their duties under the CA 2006, including the duty to promote the success of the company under section 172 CA 2006, and the duty to exercise reasonable care, skill and diligence under section 174 CA 2006. The High Court concluded that ClientEarth failed to make a prima facie case under section 261(1) CA 2006 to enable the grant of permission and did not consider that the claim would be continued by a person bound to promote the success of the company.

In relation to the scope of the duties owed under section 172, the Court held it is for the directors to decide how Shell's business should be conducted and how best to promote the success of the company. Similarly, under section 174, the Court held that the law does not specify what is reasonable in every scenario.

As to whether the duties were breached, on a prima facie basis, the Court held that the evidence submitted by ClientEarth did not demonstrate that there is a universal method for achieving the targets set by Shell's directors.

Therefore, the evidence did not demonstrate that the directors failed to manage the business in the best interests of Shell's members.

Decision

Following ClientEarth having exercised its right to ask the High Court to reconsider its May decision at an oral hearing, the High Court confirmed its earlier decision to refuse permission for ClientEarth to continue a derivative claim under Part 11 CA 2006 brought against the directors of Shell plc for alleged breaches of duties in connection with Shell's climate change risk management strategy.

ClientEarth argued that the approach of the directors to managing climate change risk was flawed and fell outside the range of reasonable responses to the risks identified by Shell. It argued that certain alleged inadequacies and deficiencies in Shell's strategy meant that the directors were in breach of their duty to promote the success of the company under section 172 CA 2006 and their duty to exercise reasonable care, skill and diligence under section 174 CA 2006.

Dismissing ClientEarth's application, the High Court held that ClientEarth had failed to establish a prima facie case that the directors acted in breach of their duties in relation to their management of Shell's climate change risk.

On 24 July 2023, ClientEarth announced that it would appeal against the High Court's dismissal of its application to continue its derivative claim against Shell. ClientEarth will initially request permission from the High Court judge to appeal his decision. If that permission is refused, the decision may be challenged in the Court of Appeal, with the Court of Appeal's permission.

This is a relatively rare example of a derivative action in respect of a UK company. Following this decision it may be difficult for activist or other types of minority investors focused on a particular issue such as climate change to prove the level of good faith required for a derivative claim.

Court of Appeal dismisses derivative claim by pension scheme members against directors for breach of directors' duties

In *(1) McGaughey (2) Davies v Universities Superannuation Scheme Limited and others* [2023] EWCA Civ 873 the Court of Appeal dismissed an appeal brought by two members of a pension scheme to continue proceedings against certain directors and former directors of the pension scheme's corporate trustee (USSL) for alleged breaches of their directors' duties by way of a common law multiple derivative claim.

Whilst there has been a decline in defined benefit/contribution pension schemes such as this scheme this case again highlights the importance of contractual protections of the rights and obligations of the parties.

Facts

The claimants alleged, amongst other things, that the directors had breached their section 171 and 172 CA 2006 duties by failing to form an adequate plan to divest from fossil fuels investments. The central issue in this appeal was whether the claims could be brought as common law company derivative claims.

Decision

The Court of Appeal held that in order to bring a multiple derivative action the company in question must have suffered a loss or harm which the claim seeks to remedy and the would-be claimant must have suffered harm or loss which is reflective of it. On the facts of the case, the Court of Appeal held that USSL had suffered no loss and, therefore, the claims were not derivative claims - there was no prima facie case that USSL had suffered a loss as a result of the alleged breaches of directors' duties. The Court of Appeal stressed that the derivative claim procedure is available only in exceptional circumstances. Its purpose is not to allow members to monitor every step taken by directors nor is it to enable would-be claimants to avoid other procedural hurdles. The case is most notable because it is the first occasion that the Court of Appeal has considered a claim that directors have breached their statutory duties in failing to take steps towards divestment in fossil fuels.

Interpretation of no "material adverse change" warranty

In *Finsbury Food Group Plc v Axis Corporate Capital UK Limited and others* [2023] EWHC 1559 (Comm), the High Court considered the construction of a no material adverse change warranty in a share purchase agreement.

Material adverse change clauses are infrequently seen in English mergers and acquisitions, however, they are more common in material commercial agreements. This case highlights the importance of clarity and precision in the drafting of material adverse change clauses.

Facts

A no material adverse change warranty claim was made by the buyers against the insurers under a Buyer-Side Warranty and Indemnity Insurance Policy which was issued in connection with the sale and purchase of the target and the corresponding sale and purchase agreement.

As a result of this disputed claim the High Court considered the construction of the warranty in the sale and purchase agreement which stated that "since the Accounts Date... there has been no material adverse change in the trading position of any of the Group Companies or their financial position, prospects or turnover and no Group Company has had its business, profitability or prospects adversely affected by the loss of any customer representing more than 20% of the total sales of the Group Companies".

Decision

The High Court found that the material adverse change warranty was "not well drafted" and should be construed as two separate warranties, with the 20% loss of sales threshold in the second warranty not to be used to define the material adverse change necessary for the first warranty.

Instead, but without detailed discussion of his rationale, the judge concluded that, on the facts, a material adverse change needed to exceed 10% of the total group sales of the target for there to be a breach of the first warranty, this being "to [his] mind a sufficiently significant or substantial change over the relevant period of 9 months". In addition, the High Court found that price reductions agreed before but not implemented until after the Accounts Date did not breach a warranty that "since the Accounts Date...no Group Company has offered or agreed to offer ongoing price reductions or discounts or allowances on sales of goods", construing the warranty to be directed at the date upon which the price reduction was offered or agreed to be offered, and not the date upon which it actually became effective.

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