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Policy & Technical Bulletin

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

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Introduction

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

Over the last year, we have seen our industry continue to adapt to a challenging climate, particularly the widespread economic implications of the ongoing conflict in Ukraine. The past six months has further tested industry's resolve, as a consequence of the domestic economic uncertainty that followed the Government's fiscal statement in September. The reversal of some of the key measures by the Chancellor of the Exchequer, Jeremy Hunt, and other measures announced at the Autumn Statement settled financial markets and restored economic confidence. The BVCA welcomed the proposed extension to the sunset clause for the Enterprise Investment Scheme and Venture Capital Trusts which was announced in September and repeated in the November Autumn Statement. The absence of tax rate rises targeted at private capital will enable the industry to continue to contribute to the growth that the UK economy needs. The BVCA also welcomed draft regulations to support private markets access to DC pension schemes (see below). We are reviewing changes to R&D tax reliefs and the impact this will have on the industry.

The BVCA's sustainability agenda continues to be an area of focus for members and committees, especially with COP27 taking place this month. Over the last six months, the BVCA has worked in partnership with iCI (Initiative Climat International) and KPMG to produce a guide for private equity firms to implement the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD). With extensive input from a range of firms and other stakeholders, the guide signposts existing practical tools, proposes a banded approach that considers different firms' characteristics and priorities and supports understanding of climate-related risks and opportunities. The focus on sustainability for firms will only increase further following the implementation of SDR (see below), the Government's independent Net Zero Strategy Review and the work being undertaken by the Taskforce on Nature-related Financial Disclosures. The BVCA has updated its statement on the PE/VC industry's contribution to Net Zero and recent guides/tools, and this is available here.

The Taxation Committee has continued to engage with key stakeholders on changes to the international tax landscape. The delay to the introduction of new rules under OECD Pillar Two has been welcomed by the BVCA, although further consideration should be given to the proposed draft legislation. At the Autumn Statement, the Government confirmed that it will legislate to implement OECD Pillar Two for accounting periods beginning on or after 31 December 2023. The EU continues to have an active tax agenda, described in this Bulletin by Jenny Wheater,

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Introduction

Christopher Gossage, Clare Copeland, Laura Charkin and Tim Hughes.

The Chair of the Taxation Committee, Mark Baldwin, along with Rhiannon Kinghall-Were, Russell Warren, Alex Christoforou and Brenda Coleman, provide an update on the Qualifying Asset Holding Company (QAHCs) regime, seven months after its implementation in April 2022. Following the Committee's engagement with HMT and HMRC, the immediate impact of the legislation was assessed in the May edition of the Bulletin. In this edition, the authors assess the remaining areas of difficulty and the BVCA's involvement in finding solutions to these areas.

On the personal tax side, the BVCA has continued to engage constructively with HMRC and HMT to find a solution to the issue affecting international private equity executives concerning double tax relief and carried interest (s103KE). Developments in this area are expected soon. The BVCA also continues to make representations to government about the tax reporting burden on investment partnerships, urging HMRC to look again at the operation of these rules in the UK.

Over the last six months, the Regulatory Committee has engaged further on FCA proposals on a number of developments that fall under the theme of retailisation and democratisation of the asset class. In this Bulletin, Nicholas Chipperfield outlines the FCA's final changes to strengthen the financial promotion rules for high-risk investments. In response to the BVCA's advocacy, the FCA amended the final rules to extend the implementation period and reduce the reporting burden on firms. Owen Lysak covers the FCA's new guidance to help firms implement the Consumer Duty which requires firms to act to deliver good outcomes for retail investors. This will be applicable to the regulated activities (and ancillary activities) of FCA authorised firms within a distribution chain that involve a retail customer (subject to certain exceptions). Paul Ellison concludes by providing an insight into the FCA's proposals to broaden pensions scheme coverage and reclassify Long Term Asset Funds (LTAFs) as Restricted Mass-Market Investments, which would allow for LTAFs to be marketed to retail investors and distributed through DC pension scheme self-select options and unit-linked Self-Invested Personal Pensions.

Tom Taylor, in his article, outlines DWP's new proposals to broaden the investment opportunities of DC pension schemes which includes a principle-based exemption from the regulatory charge cap for performance-based fees and carried interest. The BVCA has held positive engagement with DWP on reforming the current charge cap rules and worked closely with members throughout the consultation process.

SDR has been at the top of the Regulatory Committee's agenda following the FCA's proposals to introduce a common regulatory framework for sustainability disclosures in the UK. Previously covered in the May edition of the Bulletin, Tim Lewis, Chair of the Regulatory Committee and Simon Witney provide an update into the progression of the new framework following the publication of the FCA's proposals and consultation. The BVCA is now gathering members feedback on the proposals, the impact of which will depend on a firm's size (thresholds match the FCA's TCFD-aligned rules), the sustainability-related language used in product names and marketing material and whether a fund is marketed to retail investors.

The Economic Crime and Corporate Transparency Bill has been a key area of focus the Legal & Accounting Committee. In this Bulletin, Ed Hall and Chris Ormond provide insight into the BVCA's response to the Bill and engagement with BEIS on UK limited partnership legislative reform. The BVCA has worked extensively with BEIS over several years on the proposals outlined in the Bill which will grant the Register of Companies the power to deregister LPs if a court deems it is in the public interest, when a firm is no longer operating or if a LP has been dissolved. The BVCA has sought to demonstrate the unintended consequences these proposals may have on the regulatory status of existing migrated partnerships, limited liability, and administrative requirements for LPs. The corporate transparency changes and reforms to Companies House were covered in the May 2022 Bulletin.

Jonathan Martin provides an update on the draft amendments to the International Private Equity and Venture Capital Valuation (IPEV) Guidelines, published in October. The Guidelines, which were last updated in 2018 (with additional guidance published in March 2020 in response to the pandemic), includes updates for several areas and current practices including ESG.

Introduction

Clare Gaskell covers the Takeover Panel's consultation on presumptions of the definition "acting in concert", which the BVCA responded to in September 2022. Overall, the BVCA welcomed the consultation on the proposed amendments to the Takeover Code. The increase to the current threshold at which the presumption of acting in concert is engaged from 20% to 30% was welcomed. The BVCA recommended that non-participating preference shares should not be in scope of the definition, particularly where the credit fund of a PE/VC firm solely holds these shares.

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

The BVCA has updated and restructured the policy section of our website to ensure key policy content is accessible to members and other stakeholders. As well as summarising our work on key tax, legal, regulatory, and accounting files, we have included a new section dedicated to sustainability, governance, and disclosure. View updated 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 also like to extend our thanks to the excellent secretariat at the BVCA who support the work of our three committees so well. If you have any questions or would like to get more involved in the work of the committees and their working groups, please feel free to get in touch with any of us.

	New members on our committees	Members who stepped down
Taxation Committee	**Brenda Coleman** (Ropes & Gray) **Charles Osborne** (Slaughter & May) **Patricia Allen** (Ashurst) **Terry Heatley** (Grant Thornton)	**Gareth Miles** (Slaughter and May) **Tim Lowe** (Kirkland & Ellis) **Eli Hillman** (Grant Thornton)
Legal & Accounting Committee	**Ann McCarthy** (BGF) **Haris Kaufman** (Ares Management) **Jeremy Dennison** (Livingbridge) **Matt O'Toole** (CVC)	**Angel Quek** (Latham & Watkins) **John Atherton** (Ares Management)
Regulatory Committee	**Aisling Malone** (Bain Capital) **Shailen Patel** (Macfarlanes)	**Matthew Cottrell** (Carlyle)

With best wishes,

Victoria Sigeti, Chair, Legal & Accounting Committee
Mark Baldwin, Chair, Taxation Committee
Tim Lewis, Chair, Regulatory Committee
Gurpreet Manku, Deputy Director General, BVCA

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 2022 (as our last Bulletin was published in May 2022). You can find all of the BVCA's policy submissions here and the Invest Europe/Public Affairs Executive ("PAE") submissions here. The PAE includes 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	• Sovereign immunity – HMT • Pillar 2 draft legislation – HMT • Amendments to the Qualifying Asset Holding Companies regime - HMRC • Securing the Activity Framework of Enablers (SAFE) (Invest Europe response) – European Commission
Regulation	• Review of the UK Fund Regime - FCA • Broadening retail access to the LTAF – FCA • Marketing notifications under CBDF (Invest Europe response) – ESMA • Minimum safeguards under the Taxonomy (Invest Europe response – European Commission)
Legal & Accounting	• IPEV Valuation Guidelines update • The Takeover Panel Presumptions of the Definition of "Acting in Concert" and Related Matters – The Takeover Panel • Primary Markets Effectiveness Review: Feedback to the discussion of the purpose of the listing regime and further discussion – FCA
Cross-committee	• Broadening the investment options of DC schemes (charge cap) - DWP • Call for Evidence – UK Net Zero Review - BEIS • Call for Evidence on UK Green Finance Strategy update - BEIS • International Sustainability Standards Board's Exposure Drafts – IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information and IFRS S2 Climate-related Disclosures – ISSB

Legal & Accounting Committee

Name	Company
Victoria Sigeti (Chair)	Freshfields Bruckhaus Deringer
Alastair Richardson (Vice-Chair)	3i
Ann McCarthy	BGF
Ashley Coups	EY
Babett Carrier	Cinven
Benjamin Marten	Bridgepoint
Chris Bulger	Vitruvian Partners
Clare Gaskell	Simpson Thatcher & Bartlett
Ed Hall	Goodwin Procter
Elizabeth Judd	STAR Capital
Geoffrey Kittredge	Debevoise & Plimpton
Haris Kaufman	Ares Management

Name	Company
James Douglas	Linklaters
Jeremy Dennison	Livingbridge
John Heard	Abingworth
Jonathan Martin	KPMG
Jonny Myers	Clifford Chance
Karen Sands	Hermes GPE
Matt O'Toole	CVC
Nick Reid	Carlyle
Richard Mcguire	PwC
Tom Alabaster	Ropes & Gray
Vikas Karlekar	ICG
Yasir Aziz	Deloitte

Regulatory Committee

Name	Company
Tim Lewis (Chair)	Travers Smith
Mark Howard (Vice-Chair)	KKR
Aisling Malone	Bain Capital
Andrew Lewis	ICG
Christopher Crozier	Permira
Ed Kingsbury	CMS
James Smethurst	Freshfields Bruckhaus Deringer
Jason Pae	Bridgepoint
John Decesare	3i
John Morgan	Pantheon
Lindsay Hamilton	Livingbridge
Owen Lysak	Simpson Thacher & Bartlett
Paul Ellison	Clifford Chance
Peter Moore	Cinven
Shailen Patel	Macfarlanes
Simon Powell	Advent International
Will Rann (Secondee)	Travers Smith

Taxation Committee

Name	Company
Mark Baldwin (Chair)	Macfarlanes
Abigayil Chandra (Personal Tax Sub-Committee Chair)	Deloitte
Clare Copeland (Corporate Tax Sub-Committee Chair)	Carlyle
Alexander Conway	Crowe
Alexander Cox	Kirkland & Ellis
Alexandra Hone	ICG
Anthony Stewart	Clifford Chance
Brenda Coleman	Ropes & Gray
Charles Osborne	Slaughter & May
Craig Vickery	Exponent
Ed Nevens	Cinven
Elaine Gwilt	KPMG
Farhana Raval	Bridgepoint
Garry O'Neill	3i
Graham Iversen	Greenberg Traurig
Graham Taylor	EY
James Pratt	BDO

Name	Company
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Jenny Wheater	Debevoise
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Jill Hardie	Aberdeen Standard Investments
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01

Are you SAFE from DEBRA? Unpicking the latest EU tax initiatives

Jenny Wheater and Christopher Gossage (Debevoise & Plimpton), Clare Copeland (Carlyle), Laura Charkin (Goodwin) and Tim Hughes (PwC)

01 Are you SAFE from DEBRA? Unpicking the latest EU tax initiatives

The developing tax landscape in the European Union seems to involve an ever-expanding array of acronyms, which can be daunting to navigate. This article looks at the latest tax developments within the EU which are most relevant to the funds industry (demystifying those acronyms en route) and aims to highlight where any potential concerns for the fund industry may lie.

UNSHELL/ATAD3

The draft "Unshell" Directive and "ATAD3" are the same thing. To give a little background, "ATAD" is the EU's Anti-Tax Avoidance Directive adopted in July 2016 as Council Directive 2016/1164/EU. ATAD2 refers to a later iteration of ATAD. While ATAD originally contained a variety of measures seeking to implement the OECD's base erosion and profit shifting ("BEPS") agenda, such as interest expense limitations, ATAD2 amended ATAD to extend the rules relating to hybrid mismatches. Exactly the same concept is seen with the Directive on Administrative Co-operation or "DAC". This was adopted as Council Directive 2011/16/EU replacing a previous Directive on co-operation among EU Member States on the exchange of information relating to tax with a view to combatting, among other things, aggressive tax planning. Thus, "DAC6" is merely an amendment to create the sixth iteration of the DAC and adding the mandatory disclosure obligations with which fund managers are now familiar. However, ATAD3, if implemented, will be the seventh amendment to the DAC and could equally have become known as "DAC7", had not "ATAD3" emerged as the preferred moniker. There is often little logic to preferred market terminology.

Unshell, as we shall call it, was published in its proposed form in December 2021. It is aimed at ensuring that EU "shell" entities are denied the benefit of tax treaties within the EU and certain EU Directives (such as the Parent-Subsidiary Directive and the Interest and Royalties Directive). Future proposals may extend the application of Unshell to non-EU shell entities. The concept of "shell" entities is aimed, in principle, at those which have little or no commercial or economic activity in their jurisdiction of residence. To achieve this, entities which do not meet certain "gateway" criteria (on the nature of their income (active versus passive), the amount of income emanating from (or paid out to) cross-border transactions and the level of outsourcing of their activities) are deemed "at risk". At risk entities may be required to report in their annual tax return whether they meet certain minimum "substance" indicators related to premises, bank accounts and the residence of directors/employees to their local tax authority. If so, they are then presumed not to be a "shell" entity for the tax year. Failure to meet or to report on these "substance" indicators renders an entity a "shell" with the key consequence of inability to access treaties and EU Directives as described above.

From the perspective of fund managers, there is one key question arising from Unshell, namely will this have a material impact on the EU holding structures through

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which limited partnership based funds commonly invest? The short answer is that the position in this regard is currently not entirely clear. There is considerable uncertainty surrounding the development of the proposal and the political consensus needed by Member States for it to move forward.

Crucially, the draft Unshell proposal (and, in particular, the changes proposed by the European Parliament in May 2022) contains certain exemptions for entities considered to be sufficiently low risk. The BVCA has been involved in working with EU industry bodies in this area to ensure that these exemptions are crafted to take into consideration the specifics of private fund structures. In particular, the draft Directive specifically excludes regulated financial undertakings and entities owned by such undertakings and which have as their objective the holding of assets or the investment of funds. The draft text also includes an outsourcing "gateway" which seeks to allow an entity to outsource activities to personnel working within the same "associated" operations in the same jurisdiction. Whilst this "gateway" seeks to simplify the situation for holding structures that operate multiple entities within the same jurisdiction, it is unclear whether issues in applying the definition of "associates" to private fund structures will be resolved.

These exemptions and limitations, along with other matters, should, if enacted, serve to narrow the application of Unshell as regards most fund holding companies. However, the most useful provisions are yet to be approved by the European Parliament's relevant committee and the European Commission. Recent debates within the European Parliament have, in fact, included proposals from various groups to delete some of the aforementioned useful concepts. Accordingly, it remains to be seen whether the final form Directive will retain them or suffer a more major rewrite. In any event the BVCA will continue to be closely involved to ensure that the interests of the funds industry are appropriately considered.

Unshell is scheduled to come into effect from January 2024; however, as we go to print, proposals are afoot to delay implementation until January 2025. It should be noted that the draft also included a two-year look-back period for assessing whether the gateway criteria are met; if this concept is retained in the Directive, holding structures should assess the likely impact of Unshell, and assess it early.

DEBRA

DEBRA is an entirely new proposed EU Directive, namely the Debt Equity Bias Reduction Allowance Directive, and is aimed at addressing the asymmetry within most of the EU between debt and equity financing. Interest is typically tax deductible while dividends are typically not and this so-called "debt equity bias" is currently only addressed by six EU Member States (Belgium, Cyprus, Italy, Malta, Poland and Portugal). DEBRA was published in May 2022 and the period of public consultation ended in July. If approved, EU Member States should apply the rules by January 2024.

There are two sides to DEBRA. The "good" side is the deductible allowance (taken over 10 years and capped at 30% of EBITDA) in respect of increases in equity investment. The allowance is calculated by reference to a base multiplied by a notional interest rate ("NIR"). The base is essentially the difference between the net equity at the end of the tax year and the net equity at the end of the previous tax year. The NIR is the sum of two components: (i) the risk-free interest rate for the relevant currency (RFR – published for Solvency II and replacing LIBOR and EURIBOR) with a maturity of ten years for the currency in question; and (ii) a risk premium of 1% (or 1.5% for SMEs). As can be imagined, there are clawback and anti-abuse provisions but also carry forward rules. It is important to note that the equity allowance focuses on increases in equity investment; accordingly, initial investments will not benefit.

DEBRA's less appealing traits (in terms of both content and drafting) are found in the form of additional limitations on interest deductibility. DEBRA introduces a restriction on the deductibility of "exceeding borrowing costs" (taking the definition from ATAD as, broadly, borrowing costs paid less interest received). Taxpayers will, therefore, be denied deductions for 15% of the amount by which their tax deductible borrowing costs exceed their taxable interest income. There are provisions on how this will interact with the existing interest limitation rules under ATAD. Essentially, you calculate the deductible amount on the exceeding borrowing costs under DEBRA first and then ATAD. You can then deduct the lower of the two. If the deduction available under ATAD is lower, then only the difference between the deduction available under ATAD and that available

under DEBRA can be carried forward (or back) under the normal rules in ATAD. If the deduction under DEBRA is higher, the denied interest deduction is permanently lost. This is, presumably, intentional given the aim of the Directive.

DEBRA is drafted to apply to all undertakings that are subject to corporation tax in an EU Member State (including permanent establishments). While a number of "financial undertakings" (including AIFs and AIFMs) fall outside its scope, typical holding companies are not excluded and thus would, potentially, be affected by DEBRA.

Again, the key question is whether DEBRA will have a material impact on fund holding structures. The answer here is that any impact is probably not material in most cases, but there may be yet more compliance to consider and it cannot be denied that there will be an impact in some circumstances. There is much uncertainty. It should first be noted that DEBRA is very much in the early stages with consultation having only just concluded; progress is by no means a certainty. Additionally, DEBRA does bring certain advantages in relation to equity financed holding structures and could thus be beneficial. More care might be required in relation to debt financing but this should not be unmanageable, although more time investment will be needed to navigate and manage the dual set of interest limitation rules. Inevitably, some structures will be affected by the loss of relief described above if DEBRA is implemented as drafted. That said, there may yet be an exclusion for holding structures, as will (hopefully) be the case with Unshell.

SAFE

SAFE refers to a recently launched public consultation more formally entitled "Securing the Activity Framework of Enablers". It was launched in July 2022 and ended in October 2022. Little specific information is available at this stage on SAFE since there is no proposed legislation and merely potential policy options in the body of the consultation.

SAFE proposes three options designed to secure that "enablers" are prohibited from assisting in arrangements or schemes that lead to "tax evasion or aggressive tax planning" in EU Member States. This overview immediately illustrates a key challenge for SAFE in moving forward, in that attempts to define "aggressive tax planning" can often have unintentional knock-on impacts and so care will need to be taken that the scope of this concept is well thought through. This area can often descend into a moral debate which itself becomes difficult to manage and in wrapping this concept up with "tax evasion", which is already a criminal offence, the risk is that penal measures, suitable for tackling evasion, are applied to a wider range of less aggressive structures.

The three options are as follows:

- First, enablers would be prohibited from assisting with tax evasion or aggressive tax planning; a specific due diligence process would be required to demonstrate compliance with this.
- Second, in addition to the first option, enablers would either be required to register in the EU or only be in a position to perform certain tasks (e.g. filing tax returns) if so registered.
- Third, enablers would be subject to a code of conduct which provides that they will not facilitate tax evasion or aggressive tax planning.

The seemingly obvious issue with all of the above proposals is that the compliance burden will fall upon those compliant advisers and GPs who are not the primary target of the proposals and that people who are already prepared to engage in evasion and aggressive planning will simply not comply. Individuals enthusiastically pursuing a career facilitating tax evasion would seem highly unlikely to be deterred by codes of conduct, due diligence or registration requirements.

From the point of view of funds, while SAFE definitely requires monitoring, it is likely to be a compliance burden at worst and, if sensibly drafted, should not include tax professionals working "in house" at funds. In addition, this proposal does face certain key difficulties, as summarised above, and there would seem to be a reasonable chance that nothing actually comes to fruition.

BEFIT

If SAFE seems ambitious, Business in Europe: Framework for Income Taxation ("BEFIT") may be even more so. An ongoing public consultation, launched in October 2022 and concluding in January 2023, BEFIT resurrects proposals made in 2011 and 2016 for a common corporate tax system in the EU.

BEFIT is heavily based on the principles of the global minimum tax in the OECD's Pillar Two. One option is that, as with Pillar Two, it applies to groups with a consolidated revenue threshold of EUR 750 million. As an alternative, a lower threshold (not specified) is proposed, supplemented by voluntary opt in arrangements.

BEFIT proposes a common tax base and allocation of profits between Member States based on a formula reflecting Pillar Two. The starting point for the tax base would be the consolidated financial statements as amended for certain tax adjustments (otherwise a new comprehensive set of tax rules would have to be drafted). The profits allocation formula would involve consideration of assets, employment and sales by destination. In relation to assets, consideration is given to including only tangible assets or adding intangibles. Transfer pricing principles would need to continue to apply to transactions with related entities outside the consolidated group of companies subject to BEFIT, namely those not in Member States.

As with SAFE, BEFIT is more something to watch than actively consider at this time. Previous proposals of a similar nature have largely failed due to difficulties with the allocation formula. The lead from Pillar Two may assist here. However, since the EU has had some difficulty obtaining unanimous support for Pillar Two itself, BEFIT may yet fail to gain momentum.

Withholding tax procedures

While lacking an acronym, the recent public consultation on a common system for withholding tax relief in the EU is nonetheless well worth mentioning. This consultation, which ran from April-June 2022, followed a review on the issue launched by the EU Commission in September 2021. While acknowledging that the myriad of procedures currently in force can be burdensome, the review was also the result of the perceived abuse of the different processes evidenced in the "Cum/Ex" schemes operated in some Member States, notably, Germany. Accordingly, the consultation makes it clear that the main aim of any legislation will be to remove barriers to cross-border investment, but it also envisages further exchange of information between tax authorities.

The consultation sets out three potential legislation options.

- First, the establishment of common, EU-standardised forms and procedures for withholding tax refund claims and a requirement for such claims to be made electronically.
- Second, the establishment of a common EU system for relief at source, under which the correct treaty withholding tax rate is applied at the time of payment by the issuer of the security.
- Third, building on the EU's existing administrative cooperation rules to confirm entitlement to treaty benefits. This option envisages a reporting and subsequent mandatory exchange of beneficial owner-related information on an automated basis.

Legislation in this area seems likely but no option is without challenges. The OECD's TRACE project would seem to suggest that the second proposal will encounter practical issues. The third could also prove tricky with different definitions of such terms as "beneficial owner" requiring resolution for the proposals to be effective. However, it seems probable that this initiative will move forward and, since the aim is to publish new rules, it may be that the EU will follow the precedents of the Pillar Two and Unshell proposed Directives and publish a Christmas present for general consideration.

02

Update on the UK Qualifying Asset Holding Company Regime

Mark Baldwin and Rhiannon Kinghall-Were (Macfarlanes), Brenda Coleman (Ropes & Gray), Russell Warren (Travers Smith) and Alex Christoforou (EY)

02 Update on the UK Qualifying Asset Holding Company Regime

The launch of the Qualifying Asset Holding Company (QAHC) regime in the UK underlines the government's ambition to enhance the competitiveness of the UK for the asset management industry, by providing a meaningful alternative for private equity (as well as credit and real estate) funds to locate their investment holding platforms. The regime, which took effect from 1 April 2022, will prove particularly attractive for funds that have existing operations in the UK.

Why has the regime been introduced?

The introduction of the QAHC was born out of the government's wider review of the UK funds regime that encompassed both tax and regulation. Despite fund managers basing themselves in the UK, it was perceived that the UK had lost ground to other jurisdictions for fund vehicles and the entities through which investments are made. In a post-Brexit environment, there was a desire for the UK to re-establish itself as one of the leading centres for asset managers. This resulted in the government launching a consultation at Budget 2020 to address the challenges that have so far prevented the widespread use of UK holding companies in making investments, holding assets and ensuring there is no additional layer of tax compared with a direct investment.

Creating a more competitive environment was not the only driver. The other factor driving this change was the work undertaken by the OECD BEPS project which resulted in an increased appetite to co-locate fund management activity, the fund vehicle and holding structures to secure treaty benefits. The OECD's work on Action 6 in relation to anti-treaty abuse emphasised the importance of substance in the investment platform jurisdiction as a way to demonstrate that the company was not set up in that jurisdiction purely to benefit from the applicable tax relief. Over the years substance has come under increasing scrutiny by tax authorities seeking to deny treaty benefits, although there is little consensus on what it means. In practice, fund managers have often sought to satisfy this as far as possible by opting for a single location on the assumption that having the management team, the fund vehicle and the holding company in the same jurisdiction would offer sufficient substance to qualify for treaty benefits. Historically, that has been difficult to achieve when the management team was essentially based in the UK.

Meanwhile the European Commission's (EC) Unshell Directive has proposed measures to target EU based asset holding structures with minimal substance, creating an opportunity for non-EU intermediate holding companies. Although the EC indicated they would seek to introduce measures designed to counter non-EU shell entities, the recent SAFE (Securing the Activity Framework of Enablers) consultation (where action was anticipated) appears to be focussed on intermediaries providing tax advice. As the QAHC regime is designed to support the search for co-location, by providing a jurisdiction where the management team, fund and holding structures can all be established, and, in turn,

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attract and retain highly skilled professionals supporting those functions and the wider advisory community, the UK regime does not appear to be under any great threat. For more information about Unshell and SAFE, see the separate article in this Bulletin: 'Are you SAFE from DEBRA?'.

What does the regime achieve?

Despite the UK generally being regarded as an attractive holding company location due to a relatively low rate of corporation tax (currently 19% but set to increase to 25% from April 2023), no withholding tax on dividends, and a wide double tax treaty network, there were previously a number of other barriers that prevented all but the most determined from establishing an asset holding company in the UK. These included difficulties retaining the capital nature of gains on repatriation of investment returns; uncertainty around securing the Substantial Shareholding Exemption (SSE) on some disposals; and reliance on other exemptions from interest withholding tax.

Following the consultation process, a bespoke regime was developed to negate the historic frictions that had put off many in the industry from considering the UK. The regime amends aspects of the UK tax system to provide a tax neutral holding company vehicle that does not expose investors to an additional layer of tax compared with investing directly in the underlying assets.

One of the key benefits of the regime is that gains on any disposal of shares (other than the sale of shares in UK property rich companies which derive at least 75% of their value from UK real estate) are exempt. This removes the more onerous aspects of the SSE, so there is no longer a minimum holding period or requirement around the size of the stake, and provides a level of certainty that gains will be exempt at the outset of the investment.

The QAHC regime also allows interest payments from the QAHC to investors to be paid without withholding tax. Although it is possible to make payments of interest without withholding tax, this relaxation means it is no longer necessary to rely on double tax treaties and does away with the administration and expense of alternatives like the Quoted Eurobond Exemption.

The regime also makes it easier for returns from the QAHC to be passed to investors without converting gains into income. The rules allow QAHCs to buy-back shares which will provide capital treatment to shareholders (taxed at 20% or 28%) rather than paying dividends (taxed at 33.75% or 39.35%) - although capital treatment will not apply if those shares are held by a portfolio company executive (i.e. the shares are an employment related security held by a manager in a 25% subsidiary of the QAHC). Distributing proceeds out of a UK company other than in its liquidation requires the company to have sufficient distributable reserves which might not always be the case in a master holding company. The regime also provides an exemption from both Stamp Duty and Stamp Duty Reserve Tax where a QAHC repurchases shares or loan capital it has previously issued.

The QAHC regime should not create any downside for non-UK domiciled individuals as the regime includes special rules that ensures managers can benefit from the remittance basis of taxation for non-UK source income and gains derived through a UK QAHC. Without specific rules, all income and gains arising from a UK AHC would have been treated as UK source even if they derived from underlying non-UK income and gains (i.e. in the absence of the QAHC rules, using a UK AHC would convert offshore income and gains taxed on the remittance basis into UK income and gains taxed on the arising basis).

How do you qualify for the regime?

As the QAHC has been designed as a bespoke regime, it is necessary for companies seeking to use the regime to meet several eligibility conditions in order to qualify. The crucial conditions are as follows:

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UK tax resident

While a QAHC has to be UK tax resident (i.e. centrally managed and controlled in the UK) it does not need to be UK incorporated. This means that a non-UK incorporated company can move its residence to the UK in order to take advantage of the regime and also means it may be possible to access a more beneficial corporate law regime (e.g. Jersey) to make it easier to undertake share buybacks if distributable reserves might otherwise be an issue.

Ownership condition

The ownership condition is the most complex to navigate and sets the UK apart from other holding company regimes that take a more relaxed approach. This condition seeks to ensure that relevant interests held by non-Category A investors (i.e. “bad” investors) do not exceed 30%. Category A investors, the so-called “good” investors, include a range of investors such as certain diversely held qualifying funds, other QAHCs, and institutional investors like pension funds, life insurance companies and sovereign investors.

Qualifying funds consist of collective investment schemes (CISs) that meet the Genuine Diversity of Ownership (GDO) condition; CISs or alternative investment funds (AIFs) which are not closely held; or CISs or AIFs controlled as to at least 70% by Category A investors. One of the advantages of the qualifying fund satisfying the GDO condition is that it need not undertake a potentially complex and/or uncertain close company/70% analysis and need not continually monitor its status. As such, this is likely to be the favoured route to qualification. The GDO test is likely to be familiar as it is borrowed from the Offshore Fund rules and focuses on the manner in which a fund is marketed.

There are complex rules around calculating the relevant interests and so the rules require close attention to trace though indirect holdings and what may or may not constitute a relevant interest in more complex structures.

Activity condition

The main activity of the QAHC must be one of carrying on an investment business. Any other activities of the QAHC (if any) must be ancillary and not carried on to any substantial extent. This condition should be relatively easy to satisfy for private equity investments, and further guidance has been provided in relation to debt investments, where the question whether the transaction is a trading or investment one may not always be so clear.

Investment strategy

The investment strategy condition requires that the strategy of the QAHC does not involve the acquisition of equity securities listed or traded on a recognised stock exchange or any other public market or exchange, or other interests that derive their value from such securities. There is an exception to this where the acquisition is for the purpose of facilitating a change in control of the issuer so that it is no longer listed or traded. This allows public to private transactions, or stake-building prior to a takeover bid. Other than for this relaxation, the investment strategy condition is quite prescriptive in that it does not allow even a minimal stake in listed securities.

What are the problem areas?

With any new regime there are inevitably teething problems. The government is taking an active role, working with stakeholders, to resolve some of the defects with amendments to legislation or updates to guidance that can be expected over the course of the next few months. Some of the most common problem areas are described below.

One of the quirks of borrowing regulatory definitions has meant that a closed-ended fund that is a body corporate cannot use the GDO qualifying fund route to satisfy the ownership condition. This is because the ownership condition states that only a CIS can utilise the GDO condition and the regulatory definition of a CIS under section 235 of

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the Financial Services and Markets Act 2000 does not extend to body corporates unless they are an open-ended investment company. As a result, this precludes corporate closed-ended funds from the GDO route. From a policy perspective it has not been clear why the GDO test is not available in these circumstances, and furthermore, why AIFs are precluded from the GDO route. The government has listened to representations made in this regard and has put forward draft legislation to widen this test which will hopefully allow some AIFs to qualify under the GDO route.

The current framework of the ownership condition also prevents parallel partnership funds or aggregator funds from qualifying. Broadly this is because the qualifying fund GDO test is applied on an entity-by-entity basis. Common fund structures may therefore encounter difficulty meeting this test when the fund has marketed their overall structure but has provided investors with options to invest via a parallel fund. In these situations, it may be possible for the funds to qualify under the non-close tests, however the government is investigating whether it can amend the legislation to allow the GDO test to apply on a "fund overall" basis. There is some uncertainty about how this will be achieved but it is promising that there should be a fix and that the government is committed to addressing these difficulties.

There are other aspects of the QAHC regime where there is more uncertainty about whether the government will seek to rectify the issues presented. One area is the investment strategy condition. In practice it has been found to be too prescriptive as it prevents even minimal holdings of listed shares. The genesis of the condition was to prevent conversion of income into gains where dividend income could be rolled up tax free at the level of the QAHC and extracted to investors. Possible solutions could allow for a minimal holding that is demonstrably ancillary or a targeted anti-abuse rule preventing dividends from being extracted as a gain. We will need to see whether the government decides to resolve this issue or not.

Another issue that is likely to take longer to resolve is where the QAHC regime interacts with aspects of UK corporate law. One of the benefits of the QAHC regime is the ability to repatriate underlying capital gains via a share buy-back without the risk of converting it to income and without suffering a stamp duty charge. As noted, a QAHC incorporated in the UK will require distributable reserves in order to undertake a share buyback. While this will not pose an issue for a single asset QAHC, it might require deeper consideration for a multi-asset QAHC. There are certain fixes (such as incorporation in a more flexible jurisdiction or considering a reduction of capital) however they are not without their challenges. For example, the optics of a Jersey incorporated UK QAHC may not be appealing for some houses and a reduction of capital may not generate sufficient distributable reserves. Resolving corporate law issues will require the involvement of another government department (in this instance, the Department for Business, Energy and Industrial Strategy) so we can anticipate this running on a different timescale, if at all.

The BVCA is heavily involved in the HMT and HMRC QAHC working group that is tasked with developing solutions for a number of these residual issues. Once these are settled, a detailed guide on the QAHC regime will be published by the BVCA to provide additional commentary on the practical aspects of the regime.

03

Retailisation: a new trend in private capital

Nicholas Chipperfield (BVCA), Owen Lysak (Simpson Thacher & Bartlett) and Paul Ellison (Clifford Chance)

03 Retailisation: a new trend in private capital

When comparing the performance of the private equity and venture capital (PE/VC) industry with public markets, BVCA data for 2021 shows the five- and ten-year annual returns were 20.4% and 17.5%, which compares favourably to the FTSE All-Share which returned 5.4% and 7.7% to investors over the same periods[1]. Our PME analysis will be available soon.

It is this sustained level of overall outperformance that is attracting some retail investors to private capital, an asset class that has traditionally been largely the preserve of institutional and professional investors. This trend, recently coined 'retailisation' or the 'democratisation' of private capital, presents an opportunity for PE/VC fund managers to access new sources and pools of investment capital and to widen their investor base.

However, greater access to retail investors inevitably comes with greater scrutiny and there are several areas of regulation that fund managers and distributors seeking to raise capital from retail investors need to be aware of.

In this article, we provide a summary of:

- the FCA's recent changes to the **Financial Promotion rules**
- HMT's consultation proposals to tweak the **Financial Promotion Order exemptions**
- The FCA's new **Consumer Duty**
- The new authorised **Long-Term Asset Fund**

[1] BVCA publication: Performance Measurement Survey 2021

The Financial Promotion rules by Nicholas Chipperfield

The FCA has confirmed changes to its financial promotion rules for "high-risk investments", which, for the purposes of these rules, is any investment product which is not a listed or exchange-traded security. The key changes include simplification of the FCA's product marketing classifications, to which different marketing restrictions apply, and changes to the consumer journey, including new risk warnings, banning inducements, and for client categorisation and appropriateness tests.

A "financial promotion" is an invitation or inducement to engage in investment activity, communicated in the course of business, e.g. advertisements in print, broadcast and online media. The FCA's financial promotion rules hinge on the financial promotion restriction (in section 21 of the Financial Services and Markets Act 2000) that prohibits the communication of a financial promotion unless it is (i) communicated by an authorised person; (ii) has been approved by an authorised person; or is (iii) communicated under a Financial Promotion Order (FPO) exemption (see section on FPO exemptions below). A breach of the financial promotion restriction, e.g. an unauthorised person communicating a financial promotion that has not been approved by an authorised person and not in compliance with an FPO exemption, is a criminal offence.

The financial promotion rules, set out in Chapter 4 of the FCA's Conduct of Business Sourcebook (COBS 4),

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are intended to ensure financial promotions meets a minimum standard to help consumers make well-informed investment decisions, e.g. financial promotions must be fair, clear and not misleading. In addition to the overarching standards, there are various marketing restrictions that apply to different classifications of investment product.

The following changes were consulted on earlier this year (the BVCA's consultation response is available here) and will come into force on 1 February 2023 (except those for risk warnings which apply from 1 December 2022):

- **Restricted Mass Market Investments (RMMI):** RMMIs is a new investment product classification that will consolidate and replace the existing product classifications for Non-Readily Realisable Securities (NRRS) and Peer-to-Peer (P2P) agreements, and includes unlisted securities, P2P agreements, EIS/SEIS (by exemption from the Unregulated Collective Investment Scheme (UCIS) definition), and Long-Term Asset Funds (subject to the outcome of an FCA consultation). RMMIs can be mass-marketed to retail investors. However, investors must pass an appropriateness test, which assesses the appropriateness of the product based on the investor's knowledge and experience. A "Restricted investor", i.e. those that do not meet definitions of a high net worth individual or sophisticated retail investor (see section of FPO exemption below), can only invest up to 10% of their net investible assets in RMMIs.
- **Non-Mass Market Investments (NMMI):** NMMI will replace the existing classifications for Non-Mainstream Pooled Investments (NMPI) and Speculative Illiquid Securities (SIS). NMMIs include UCIS, Qualified Investor Schemes (QIS) and SISs, which is a debenture or preference shares where the proceeds are used to on-lend, invest or for buying or developing property. NMMIs cannot be mass-marketed to retail investors and can only be marketed to high net worth individuals or sophisticated retail investors who have passed a preliminary assessment of suitability, which requires the distributor to acquaint itself with the investor's profile and objectives and judge whether the investment is likely to be suitable.
- **New risk warnings:** "Capital at Risk" warnings will need to be replaced by the following new risk warning on all financial promotions for RMMI and NMMIs:
  "Don't invest unless you're prepared to lose all your money invested. This is a high-risk investment. You could lose all the money you invest and are unlikely to be protected if something goes wrong. Take 2min to learn more."
  For online financial promotions, "Take 2min to learn more" must link to a new section with prescribed risk information. There is also a new personalised risk warning that must be used for new customers, which must include the prospective investors name.
- **Ban on inducements:** the FCA has banned inducements to invest, such as refer a friend and new-customer bonus and discount schemes for NMMI and RMMIs.
- **Cooling off periods:** new customers must wait at least 24-hours after receiving the personalised risk warning before they can invest.
- **Investor declarations:** Customers categorising themselves as high net worth individuals will have to provide the distributor with their level of income to the nearest £10k, or net assets to the nearest £100k for financial promotions related to an NMMI or RMMI.

The FCA has also proposed changes to the appropriateness test (required by COBS 10 or 10A), including new guidance on the type of questions that firms should be asking when assessing appropriateness, and a new rule that means firms cannot re-assess appropriateness for at least 24-hours after failure of a second consecutive appropriateness test.

Firms communicating financial promotions to retail investors will also be required to keep records of the number of customers that categorise themselves as high net worth individuals or sophisticated investors and the number of customers that drop out at the investor categorisation stage. Firms will also be required to keep records on the outcome of appropriateness assessments for each customer and the number of retakes they have taken, if any.

The Financial Promotion Order exemptions by Nicholas Chipperfield

Earlier this year, HM Treasury consulted on changes to the FPO exemptions for certified high net worth individuals, certified sophisticated investors, and self-certified sophisticated investors.

As alluded to in the section on the financial promotion rules (above), the FPO exemptions enable unauthorised persons to lawfully communicate financial promotions to certain types of investors without the need for approval by an authorised person or being subject to the FCA's financial promotion rules. As things stand, firms relying on FPO exemptions must "believe on reasonable grounds" that the recipients of the financial promotions are:

- **Certified high net worth individuals:** Article 48 of the FPO covers individuals who have signed a statement that they have an income of £100k or more in the last year, or net assets of £250k or more (excluding their primary residence and pensions). HM Treasury have proposed increasing the thresholds to £150k income and £385k net assets, which (at the time of consultation) was in line with inflation from when the thresholds were introduced and last reviewed in 2001. An alternative proposal was to increase the thresholds to £175k income and £900k net assets which would mean the definition only captures the top 1%, as was the case when the thresholds were first introduced. This exemption can only be used to market investments related to unlisted companies.
- **Certified sophisticated investors:** Article 50 of the FPO provides for investors who have a certificate signed within 3 years by an authorised person stating that they are sufficiently knowledgeable to understand the risks associated with the relevant type of investment; and have themselves signed a certificate within 12 months stating they qualified for this exemption and understood the implications. There are no changes proposed by HM Treasury to this exemption.
- **Self-certified sophisticated investors:** Article 50A which applies to investors that have signed a statement that they meet one of the following criteria:
  - They are a member of a network or syndicate of business angles (and have been for at least 6 months).
  - They have made more than one investment in an unlisted company in the last 2 years. HM Treasury proposed to remove this criterion from the exemption.
  - They are working or have worked in the last 2 years in a professional capacity in the private equity sector or in the provision of finance for SMEs.
  - They are currently or have been in the last 2 years a director of a company with an annual turnover of at least £1m. HM Treasury propose to increase the annual turnover threshold to at least £1.4m to account for inflation.

  Like the high net worth individual exemption, this exemption can only be used to market investments related to unlisted companies.

HM Treasury has also proposed to require firms to have "reasonable belief" as opposed to "believe on reasonable grounds" that a prospective investor meets an FPO exemption criteria, and to document its conclusions.

The Government's response, confirming whether HM Treasury will be taking forward changes to the FPO exemption is now long overdue. In the meantime, the BVCA's consultation response can be found here.

The Consumer Duty by Owen Lysak

The FCA has introduced a new "Consumer Duty" to encourage higher standards of consumer protection in retail markets.

The Consumer Duty applies in relation to "retail market business", which includes regulated activities of a firm in a distribution chain including manufacturers and distributors, which involves a retail customer. There are couple of exceptions to this for non-retail financial instruments, including the manufacture of a product only marketed and approved for distribution to non-retail customers.

The rules bring in a new Principle 12 – "A firm must act to deliver good outcomes for retail customers". "Retail customer" for this purpose is defined broadly and includes not only retail clients of a firm but also, where a firm is involved in a distribution chain, persons who are the end retail customers in a distribution chain who are not direct clients of the firm. In guidance, the FCA has clarified that the Duty will apply to those firms that can determine or 'materially influence' retail customer outcomes rather than all the firms in the distribution chain.

The good outcomes that the new rules introduce are:

- Products and services that meet customer needs and are suitable
- Fair value for the price of a product or service
- Customer understanding throughout the customer journey
- Appropriate customer support

The FCA expects firms to show evidence of what customer outcomes are being achieved and how firms are assuring themselves that these outcomes are being met. The FCA expects firms to regularly review and monitor the outcomes that their customers are experiencing.

In furtherance of its outcomes-focussed approach, the FCA has made three cross-cutting rules:

- **A firm must act in good faith towards retail customers.** The FCA regards acting in good faith as a standard of conduct characterised by honesty, fair and open dealing and acting consistently with the reasonable expectations of retail customers, and has provided guidance that "reasonable expectations" depends on the nature and quality of the product or service, among others.
- **A firm must avoid causing foreseeable harm to retail customers.** Where a firm can reasonably foresee harm to a customer, it should act where possible and alert other relevant parties. Firms are not required to protect consumers from risks that they have understood and accepted.
- **A firm must enable and support retail customers to pursue their financial objectives.** The FCA's expectation is for firms to take responsibility for establishing an environment in which consumers can act in their interests.

Private equity managers whose funds are made available to retail investors (either directly or through distributors), which might include high net worth investors or employee participation, will need to consider the rules.

Managers in scope needed to have implementation plans agreed by their boards by 31 October 2022 and to have completed internal reviews in the context of cross-cutting rules by 30 April 2023. The rules apply to new investments and existing investments that are for sale from 31 July 2023, and to closed investments one year later.

The Long-Term Asset Fund by Paul Ellison

The FCA has created the LTAF (Long Term Asset Fund) as a vehicle for open-ended investment in illiquid long-term assets. LTAFs are 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). LTAFs can be marketed to professional and, under new FCA proposals, certain sophisticated retail investors. The open-ended nature of an LTAF means that investors can subscribe and redeem their units in an LTAF on an ongoing basis. However, redemptions are banned from taking place more frequently than monthly in order to mitigate the risk of liquidity mismatch given the underlying nature of the assets.

To date, LTAFs have largely been restricted to professional investors – treated as a "Non-Mainstream Pooled Investment" (NMPI), soon to be rebranded as a Non-Mass Market Investment (NMMI). However, the FCA recognises that some retail investors may want to invest in alternative assets for diversification purposes or in search of higher returns and that the LTAF, as a regulated vehicle, is subject to more stringent regulatory oversight than other types of (often unregulated) NMPI. Therefore, the FCA

has consulted on changing the categorisation of LTAF s for marketing purposes to “Non Readily Realisable Security”, soon to be renamed “Restricted Mass Market Investment” (RMMI) (see section on the Financial Promotion rules above).

This seemingly technical change could be significant to the retailisation agenda in allowing certain retail investors to participate in LTAFs as it would allow direct retail participation in LTAFs where certain conditions are complied with. Firstly, defined contribution (DC) pension schemes will be permitted to invest into LTAFs directly where the plan holder is invested in the “default” portion of the scheme (on the basis that in such circumstances it is in practice the regulated investment manager appointed by the scheme who is taking the investment decisions). Secondly, other retail investors (including execution only; self-selected defined contribution pension schemes and SIPPs) will be able to invest if prescribed marketing requirements including the provision of adequate risk warning and a risk summary are complied with where the investor falls into one of a limited number of categories, including restricted investor (subject to a 10 per cent limited); high net worth investor; self-certified sophisticated investor; and certified sophisticated investor).

Allowing DC pension schemes to benefit from the return profile of long-term illiquid assets, like PE/VC funds, will help to level the playing field between them and defined benefit pension funds which due to their structure have always been able to invest in more illiquid asset classes. The proposals also introduce an appropriateness test with a view to ensuring that retail investors only participate in LTAFs where they have an appropriate level of knowledge and experience. Linked to these proposals, the FCA has also proposed to allow Non-UCITS Retail Schemes set up as a fund of alternative investment funds (NURS-FAIF – an existing form of alternative retail authorised fund) to invest up to 35 per cent of its value into units of a single LTAF and up to a maximum of 50 per cent of its value in LTAFs in total. The FCA’s consultation has now closed and we can expect to see the FCA’s final proposal in early 2023.

04

DC pensions charge cap set to accommodate performance fees (and carried interest?) from 2023

Tom Taylor (BVCA)

04 DC pensions charge cap set to accommodate performance fees (and carried interest?) from 2023

The story so far: moving towards reform of the charge cap

With defined benefit pension schemes increasingly closing to new members, the BVCA has been working for a number of years on securing access to our asset class for UK defined contribution pension schemes, whose combined AUM is expected to top £1tn by 2030.

Many of the barriers preventing DC access are structural, market-related or operational, and the BVCA has been working on several of these issues through our membership of the Productive Finance Working Group ("PFWG"). The PFWG is a Bank of England, FCA and HM Treasury-sponsored industry forum that was created in 2020 to identify practical steps towards addressing the various of barriers preventing UK DC schemes (amongst others), from investing in illiquid (or "productive") assets like private capital funds. In 2021, the group published recommendations on what those practical steps should be, in its "Roadmap for Increasing Productive Finance Investment".

The PFWG's roadmap also highlighted a concrete, regulatory barrier, in the form of the Government's charge cap for DC default schemes, and included a specific recommendation that the Department of Work and Pensions ("DWP") should look again at excluding well-designed performance fees from the charge cap calculation. The BVCA has long advocated for such a change, in the PFWG, to the FCA, HM Treasury and the DWP, and through various political channels (including the Taskforce on Innovation, Growth and Regulatory Reform). Further detail on why the charge cap is a barrier and BVCA advocacy on this issue over the past few years are available in our May 2021 and November 2021 Technical Bulletins, and on our website. In summary, our position is that carried interest and well-designed performance fees contain inherent protections for DC pension savers, are consistent with the policy objective of the charge cap, and can safely be excluded from the cap's calculation methodology.

Previous DWP consultations

The DWP has conducted several consultations on the charge cap in recent years, the range of responses to which has underlined that the BVCA position on this issue, although supported by many, is not universally adhered to by the pension funds industry and amongst other stakeholders. The Government, apparently convinced that DC schemes should have the freedom to invest in private capital and other illiquid asset funds where their trustees/managers believe such funds offer value for their members, has nevertheless pressed ahead with proposing changes to the charge cap rules, via two consultations this year.

The first DWP consultation on this issue in 2022, which closed in April, asked whether excluding "well-designed performance fees" was the right approach and whether specific design features should be prescribed within any such exclusion. The BVCA response argued instead for

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a principles-based approach, to accommodate the range of potential fund structures, incentive arrangements (including carried interest) and asset classes that DC schemes might seek. We believe that any exclusion needs to cover innovative performance fee structures as well as carried interest, because of the possibility that some DC schemes might, for operational and other reasons, initially prefer to invest in illiquid assets through specially-designed, open-ended structures like the Long Term Asset Fund (discussed in the context of the article on 'retailisation' above and more broadly in the November 2021 Technical Bulletin).

BVCA welcomes the DWP's latest consultation on a principles-based exclusion

We were therefore encouraged by a second DWP consultation, which closed in November and proposed introducing a principles-based exclusion, accompanied by guidance to help DC trustees and managers ensure that any performance-based incentives align DC scheme members' interests with those of any illiquid asset fund managers their scheme may choose to invest with. The proposed exclusion would apply to "specified performance-based fees", which would be defined in the relevant regulation as follows:

> *"specified performance-based fees" means fees, or any part of those fees, which are–*
> ***(a)** payable by the trustees or managers of a pension scheme to a fund manager in relation to investments managed by the fund manager for the purposes of the scheme;*
> ***(b)** calculated only by reference to investment performance, whether in terms of the capital appreciation of those investments, the income produced by those investments or otherwise;*
> ***(c)** only payable when—*
> *(i) investment performance exceeds a pre-agreed rate, which may be fixed or variable; or*
> *(ii) the value of those investments exceeds a pre-agreed amount;*
> ***(d)** calculated over a pre-agreed period of time; and*
> ***(e)** subject to pre-agreed terms designed to mitigate the effects of short-term fluctuations in the investment performance or value of those investments.*

The BVCA response to this second consultation was broadly supportive of the Government's general approach and applauded the principles-based nature of the proposed exclusion for "specified performance-based fees". However, we also suggested a number of changes to the draft amendments that might be required in order to provide DC schemes and their advisors with greater legal certainty when investing in private capital fund of funds strategies and vehicles using carried interest arrangements (as well as the "well-designed" (i.e. those that offer effective alignment) NAV-based performance fee structures we expect to feature in open-ended products that firms design specifically for DC schemes).

04 DC pensions charge cap set to accommodate performance fees (and carried interest?) from 2023

Next steps: "the direction is set"

Ministers have clearly stated that "the direction is set, and we intend to legislate by spring 2023", so we expect new regulations based on the latest consultation to be finalised in the new year, before coming into force in Q2/Q3 2023. We are hopeful that the DWP will take into account BVCA members' feedback, set out in detail in our consultation response, and that the exclusion will be calibrated in a way that offers DC schemes the same freedom to invest in illiquid assets enjoyed by other institutional investors, where they deem a particular product to represent good value-for-money and be in their members' best interests.

We are also expecting the PFWG, as part of its work on addressing the other, non-regulatory barriers identified in last year's report, to publish further material to help DC trustees/managers, consultants and other market participants facilitate greater DC scheme investment in illiquid assets like private capital funds.

The BVCA will keep members informed of developments in these, and any other areas related to DC scheme investment in private capital funds, via our regular, ongoing member communications.

05

The FCA's Sustainability Disclosure Requirements and Labelling Regime

Tim Lewis and Simon Witney (Travers Smith)

05 The FCA's Sustainability Disclosure Requirements and Labelling Regime

In October the FCA published its consultation paper on the proposed new sustainability disclosure requirements (SDR) regime and a set of consumer-friendly sustainability labels. This is, in effect, the UK's answer to the EU Sustainable Finance Disclosure Regulation (EU SFDR), although it diverges significantly from the EU rules. In particular, the proposed UK regime includes rules on marketing and product names and an optional product labelling regime. It will use international accounting standards for entity level disclosures. The new regime will sit alongside rules already in force that require many UK firms to report climate-related risks and opportunities in accordance with the TCFD guidelines.

The deadline for providing comments is **25 January 2023** and a policy statement, with final rules, is expected by **30 June 2023**. A new "anti-greenwashing" rule – applicable to all regulated firms – would come into force on publication of the finalised rules. The detailed new rules on investment labelling and sustainability disclosure would become effective from **30 June 2024** for some firms, and later for others.

While the consultation proposals reflect and build on the broad approach outlined in the November discussion paper (DP21/4), the draft rules and policy proposals have evolved, following the FCA's consideration of a number of industry responses, including a response from, and meeting with, the BVCA.

The FCA proposes that, at least initially, the new rules will apply to UK-regulated asset managers and the products that they manage or distribute. It will consult at a later date on extending to scope to non-UK funds and also to pension products.

Scope, application and implementation

In-scope firms and products

Aside from the anti-greenwashing rule, which will apply to all regulated firms, the new rules on labelling, disclosure, naming and marketing and distribution will generally apply, or otherwise be relevant, to:

- **asset managers** for the purposes of the FCA's ESG Sourcebook – that is, **full-scope UK AIFMs, small authorised UK AIFMs, UK UCITS management companies** and **ICVCs** that are UCITS schemes without a separate management company and **portfolio managers** (together referred to as **"in-scope firms"**),
- in relation to **"sustainability in-scope business"** – that is, managing an AIF, managing a UK UCITS and (subject to some conditions) portfolio management, signed a statement that they meet one of the following criteria:
  - and so, in terms of products, this means **unauthorised AIFs** (including investment trusts), **authorised funds** (excluding feeder funds and funds in the process of winding up or termination) and **portfolio management**

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services (subject to conditions) which are collectively referred to as "in-scope products",

- where that business is carried out from an establishment maintained by the firm in the UK.

"Portfolio management" has an extended meaning under the existing rules in the ESG Sourcebook: in addition to the regulated activity of discretionary portfolio management, it captures private equity and other private market activities consisting of either advising on investments or managing investments on a recurring or ongoing basis in connection with an arrangement the predominant purpose of which is investment in unlisted securities. That said, only some of new sustainability rules apply when the sustainability product is an agreement or arrangement under which a firm provides a client with such portfolio management. This means that the rules are narrower for a UK based "portfolio manager" providing services to (for example) a Luxembourg, Irish or Channel Islands fund manager, when compared to a UK full-scope AIFM.

Potentially out of scope asset management firms

Firms with assets under administration or management which amount to less than £5bn (calculated as a 3-year rolling average on an annual assessment) are currently exempt from the FCA's climate related disclosures under ESG 2. Under the new regime they will also be exempt from the requirements relating to the sustainability entity report, but not – on the face of the rules as currently drafted – from the other new consumer-facing and detailed product-level disclosure requirements, at least not by virtue of their size alone.

Overseas funds/products

The FCA clearly states that overseas products are excluded from the in-scope products described above. However, they intend to consult separately on extending the regime to overseas products.

Scope and implementation of elements of the new SDR and labelling regime

In light of the above, and although the detailed rules should be referred to in all cases, the scope and application of the various components of the new regime can be summarised as below:

Element of the regime	Which firms are caught?	What products are caught?	Date of application*
Anti-greenwashing rule	**All regulated firms**	All the firm's products and services	30 June 2023
Sustainable investment labels *Labels can be used for products marketed to retail investors and for those marketed to institutional investors, in either case if the firm chooses to do so AND products meet qualifying criteria*	All in-scope firms (other than portfolio managers) **which use a label**	Unauthorised AIFs and authorised funds where label qualifying criteria are met	30 June 2024
	Portfolio managers **which use a label**	Portfolio management services (label only permitted if if 90% or more of the value of all constituent products in which they invest qualify for the same label)	30 December 2024

05 The FCA's Sustainability Disclosure Requirements and Labelling Regime

Element of the regime	Which firms are caught?	What products are caught?	Date of application (expected)
Consumer-facing disclosures (which should be kept up to date)	All in-scope firms marketing in-scope products **to retail investors** (regardless of whether they qualify for and choose to use a label)	Unauthorised AIFs and authorised funds N.B. Firms providing portfolio management services are <u>not</u> required to produce customer-facing disclosures, but will be required to provide an index of the underlying in-scope products, linking to relevant label and consumer-facing disclosure, as applicable	30 June 2024
Pre-contractual disclosures (which will need to be kept up to date), if there are any pre-contractual materials	All in-scope firms (other than portfolio management firms) using a sustainable investment label All in-scope firms (other than portfolio management firms) not using a sustainable investment label but **where sustainability-related features are integral to the investment policy and strategy**	Unauthorised AIFs and authorised funds. N.B. Firms providing portfolio management services will not be required to produce pre-contractual disclosures – but will be required to provide access to the pre-contractual disclosures for the underlying in-scope products – or under the 'on demand' regim	30 June 2024
Ongoing sustainability-related performance information	All in-scope firms **using a sustainable investment label** (other than UK AIFMs managing unauthorised AIFs not listed on a recognised exchange and firms providing portfolio management services)	All in-scope products (other than unauthorised AIFs not listed on a recognised investment exchange and portfolio management services) **where there are no pre-contractual materials** – Part A of the sustainability product report (essentially the same information as required for pre-contractual disclosures) All in-scope products (other than unauthorised AIFs not listed on a recognised investment exchange and portfolio management services) – Part B of the sustainability product report N.B. Firms providing portfolio management services will not be required to produce Part B of the sustainability product report – instead will be required to provide access to the relevant reports for the underlying in-scope products	30 June 2025

05 The FCA's Sustainability Disclosure Requirements and Labelling Regime

Element of the regime	Which firms are caught?	What products are caught?	Date of application (expected)
Ongoing sustainability-related performance information: 'On demand' regime	UK AIFMs Portfolio management firms	Unauthorised AIFs not listed on a recognised exchange Portfolio management services N.B. Such firms will be required to provide information equivalent to the content of Part A (as applicable) and Part B of the sustainability product report to clients on demand, where those clients require the information to meet their own legal obligations	**1 July 2025** (first requests under the "on demand" regime)
Entity-level disclosures	All in-scope firms with AUM ≥ £50 billion	Overall assets managed in relation to in-scope business – Sustainability Entity Report	**30 June 2025**
	All in-scope firms with AUM < £50 billion but ≥ £5 billion	Overall assets managed in relation to in-scope business – Sustainability Entity Report	**30 June 2026**
Naming and marketing rules (other than the "anti-greenwashing" rule)	All in-scope firms when marketing to **retail investors**, that do not use a label	All in-scope products	**30 June 2024**
		Portfolio management arrangements N.B. Such firms will be exempt from the naming and marketing rules when 90% or more of the value of the constituent products qualify for any label	**30 December 2024**
Distributors	Firms that are distributors of in-scope products to **retail investor**s (including platforms and advisers)	All in-scope products distributed to retail investors	**30 June 2024**

Sustainable investment labels

Simplification

The FCA's proposals have developed since the discussion paper. As a result of industry responses, the labelling regime has been simplified. In place of the suggested five categories, the consultation now proposes three simpler, more consumer-friendly labels. The additional categories or labels set out in the discussion paper – "responsible investments" and "not promoted as sustainable" – have been dropped.

Application

Although primarily designed to provide a relatively easy-to-understand set of labels for **retail investors**, many funds with **institutional investors** may be interested in using such labels (or may be subject to investor pressure to use them). They will be allowed to do so if they meet the qualifying criteria. **Even if the qualifying criteria are met, the use of labels remains optional for all firms, including those with retail investors.**

Intentionality and no hierarchy

The labelling of products is based on "intentionality" (particularly as regards the sustainability objective the firm is seeking to achieve) and is intended to describe one of three primary channels and investor contribution mechanisms by which an investor may plausibly contribute to positive outcomes. The FCA is at pains to stress that there is no hierarchy; they are different labels designed to describe different profiles of assets. However, underneath the consumer-friendly labelling and descriptions, there are some detailed qualifying criteria. **Importantly, if a product does not have a sustainability objective and does not satisfy any of the other prescribed overarching and specific qualifying criteria, a label cannot be used.**

The three labels

The table below summarises the three labels and the objectives, investment channels and qualifying criteria that underpin them.

Label:	'Sustainable focus'	'Sustainable improvers'	'Sustainable impact'
Consumer-facing description:	Invests mainly in assets that are sustainable for people and/or planet	Invests in assets that may not be sustainable now, with an aim to improve their sustainability for people and/or planet over time	Invests in solutions to problems affecting people or the planet to achieve real-world impact
Sustainability objective (alongside financial risk/return objective):	Products with an objective to maintain a high standard of sustainability in the profile of assets by investing to (i) meet a credible standard of environmental and/or social sustainability; or (ii) align with a specified environmental and/or social sustainability theme.	Products with an objective to deliver measurable improvements in the sustainability profile of assets over time The products are invested in assets that, while not currently environmentally or socially sustainable, are selected for their potential to become more environmentally and/or socially sustainable over time, including in response to the stewardship influence of the firm	Products with an explicit objective to achieve a positive, measurable contribution to sustainable outcomes Invested in assets that provide solutions to environmental or social problems, often in underserved markets or to address observed market failures

Label:	'Sustainable focus'	'Sustainable improvers'	'Sustainable impact'
Label/category specific qualifying criteria (in addition to general, overarching criteria and cross-cutting obligations):	At least 70% of product's assets must meet a credible standard of environmental and/or social sustainability, or align with a specified environmental and/or social sustainability theme If for reasons beyond the firm's control the assets cease to meet the above requirements, the firm must take action to restore compliance as soon as reasonably practicable	The firm must disclose clearly where the product will and will not invest, and describe its asset selection and stewardship activities The firm must also describe how it assesses the potential for the sustainability profile of assets to improve over time (clear and measurable target must be reflected in KPIs)	The firm must ensure that the product's sustainability objective aims to have a pre-defined, positive, measurable real-world outcome in relation to an environmental and/or social outcome The firm must develop a "theory of change" – i.e. a comprehensive description and illustration of how and why a desired change is expected to occur in a particular context. It must also develop a robust method to show how its investment activities have had a positive real-world impact and an escalation plan in case achieving that impact is no longer achievable The firm must, in specifying KPIs, apply enhanced impact measurement and reporting based on industry best practices

Qualifying criteria

In order to qualify for one of the above sustainable investment labels, a product must also apply five general, overarching principles:

- **Sustainability objective** – a firm must ensure that a sustainability product has an explicit sustainability objective.
- **Investment policy and strategy** – a firm must ensure that a sustainability product's investment policy and strategy are aligned with its sustainability objectives.
- **KPIs** – a firm must have in place credible, rigorous and evidence based key performance indicators for the purposes of measuring a sustainability product's ongoing performance towards achieving its sustainability objective.
- **Resources and governance** – a firm must apply and maintain appropriate resources, governance and organisational arrangements commensurate with the delivery of the product's sustainability objective.
- **Investor stewardship** – a firm must maintain an active investor stewardship strategy and resources at both firm and product level, consistent with the product's sustainability objective.

The FCA says that any products which, for instance, promote themselves as "ESG-integrated" and which employ exclusion/negative screening strategies, will not qualify for a label on those grounds alone.

No label means naming and marketing rules apply

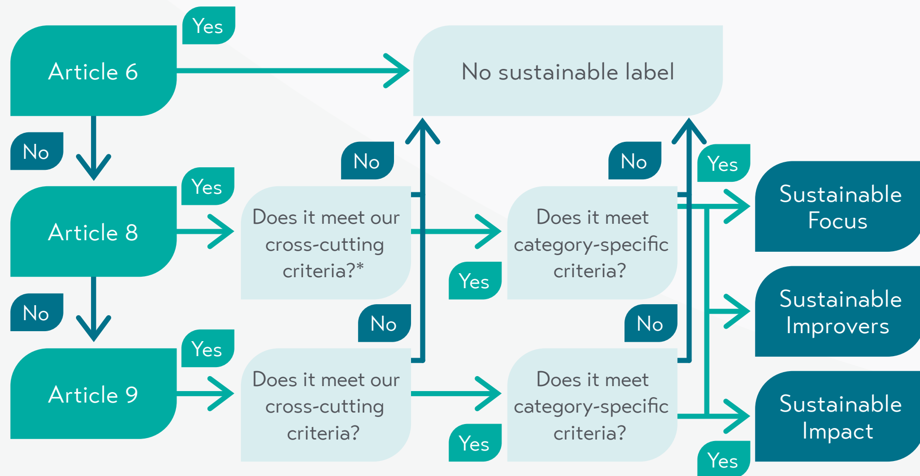
Any in-scope products which are not labelled, for whatever reason, must instead comply with the FCA's new "naming and marketing" rules where there are retail investors.

How does the labelling system correlate with international requirements?

The FCA recognises that many firms are already subject to EU SFDR, with its categorisation of products into Article 6, Article 8 ("light" and "mid green") and Article 9 products which (despite EU statements to the contrary) has become a de facto labelling system.

In Annex 1 of the consultation paper, the FCA suggests that a product categorised under EU SFDR can be mapped across to the proposed UK labelling system as follows:

Is your product?



*Note that Article 8 funds will need to 'level up' to meet our criteria by specifying a sustainability objective. it is unlikely that an Article 8 fund would meet the criteria for Sustainable Impact.

Financial Conduct Authority Discussion Paper 22/10

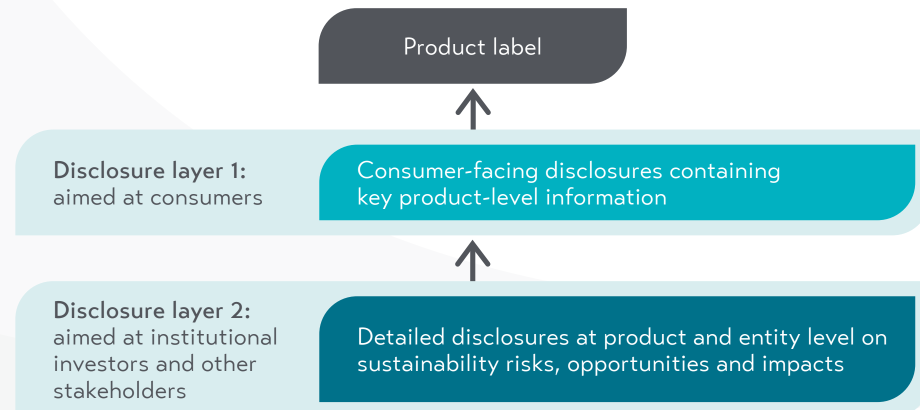
The FCA says that an Article 8 product may have to "level up" because of the need to meet the new overarching requirement under the UK labelling regime to specify an explicit sustainability objective.

There is a similar flowchart in Annex 1 looking at how a product categorised under the SEC's proposals should be mapped across to the sustainable labels (if at all).

Disclosures

Broadly, the FCA intends to proceed with the structural approach to disclosures outlined in its November 2021 discussion paper, with a set of consumer-facing disclosures (containing a subset of more detailed product-level information) and a second layer of more detailed disclosures aimed at institutional investors and other stakeholders (including retail investors seeking more information than is provided in the label and the consumer-facing disclosures).

As outlined in the discussion paper, the disclosures would form a three-tiered system as follows:



Financial Conduct Authority Discussion Paper 21/4

Consumer-facing disclosures

The consumer-facing disclosures would complement, where relevant, the labels outlined above and provide key, standardised sustainability information for consumers to make investment decisions.

Application

All in-scope firms marketing in-scope products to **retail investors** will be required to make these disclosures, regardless of whether or not they qualify for and choose to use a sustainable investment label (but excluding firms providing portfolio management services). Firms providing portfolio management services will not be required to produce consumer-facing disclosures, but will instead be required to provide an index of the underlying in-scope products, linking to their label and consumer-facing disclosure as applicable.

Detailed disclosures at product and entity level

General application

Broadly, these disclosures will supplement the information included in the consumer-facing disclosures and, while they will **be aimed primarily at institutional investors**, they may be relevant to other stakeholders, including **retail investors** who may be seeking further information over and above the consumer-facing disclosures. The disclosures would be made both at product level and at entity level.

Product-level disclosures

Broadly, in terms of detailed product-level disclosures these will consist of:

- ***Pre-contractual disclosures:*** setting out the sustainability-related features of an investment product, and to be included in a dedicated section of the fund prospectus or other prior information document (as required under FUND 3.2 for full scope UK AIFMs):
  - The requirement to make these disclosures will apply to all in-scope firms using a sustainable investment label.
  - If the product does not use a label, but nonetheless has sustainability-related features central to the firm's investment policy and strategy, then the expectation is that they will also be included in pre-contractual disclosures.
  - While firms that provide portfolio management services will not be required to produce their own pre-contractual disclosures, they will still have to provide retail investors with a way of linking to the underlying disclosures.
  - Where a product neither qualifies for a label nor adopts any sustainability-related policies and strategies, the firm will not have to make any pre-contractual disclosures.
  - The first pre-contractual disclosures will be required to be made available at the same time as the label and consumer-facing disclosures above – that is, depending on when the rules are finalised and effective, from 30 June 2024.

- ***Sustainability product report:*** this will contain ongoing sustainability-related performance information. The intention is that this will build on the existing requirement for a TCFD public product-level sustainability report as required by the FCA's Environmental, Social and Governance sourcebook (**ESG**):
  - Where the product does not have a fund prospectus or other pre-contractual disclosure requirements, firms will be required to publish "Part A" of their sustainability product report in a prominent place on a relevant digital medium where the product is offered, such as on product webpage.
  - "Part B" of the sustainability product report will only be required in relation to products using a sustainable investment label (except for firms providing

portfolio management services and UK AIFMs managing unauthorised AIFs not listed on a recognised exchange – see below).
- The sustainability product report must be published in a prominent place of the firm's website and must include the information required in ESG.
- While firms that provide portfolio management services will not be required to produce their own sustainability product reports, they will still have to provide retail investors with a way of linking to the relevant underlying disclosures.

As with the "on demand reporting" provisions of the ESG/TCFD rules, there will be recognition that public disclosures are not appropriate in some situations, significantly in the context of (i) UK AIFMs managing unauthorised (and unlisted) AIFs and (ii) firms that provide discretionary portfolio management services to individuals or institutional investors. Where such firms choose to use a label for these products, and their clients need the information to satisfy their own sustainability disclosure obligations, the firm will be required to make non-public disclosures to the client on request on an annual basis. The client will not be able to make such a request before 1 July 2025, in respect of a calculation date no earlier than 30 June 2024 (assuming the new rules enter into force on 30 June 2023).

Entity-level disclosures

Application

In terms of the detailed entity-level disclosures, all in-scope firms with assets under management of £5 billion or more will be required to produce a sustainability entity report in relation to their in-scope business. Firms with assets under administration or management amounting to less than £5bn calculated as a 3-year rolling average on an annual assessment will be exempt from the new entity-level disclosures (though apparently not from the other disclosure requirements, if relevant).

This requirement for a sustainability entity report will be phased-in in similar fashion to the introduction of the exiting TCFD-aligned disclosure requirements. Large asset managers with assets under management of more than £50 billion will be required to make their first entity-level disclosures by 30 June 2025. Other asset managers with more than £5 billion AUM will be required to make their first disclosures by 30 June 2026.

Naming and marketing

There are two elements to the FCA's proposals in relation to naming and marketing.

"Anti-greenwashing" rule – all regulated firms

First, a new, general "anti-greenwashing" rule is being introduced which will apply to **all regulated firms**. It is designed to ensure that any reference to the sustainability characteristics of a product or service is consistent with the sustainability profile of the product or service and that it is clear, fair and not misleading.

This rule will come into force as soon as the final rules are published – which, as currently proposed, is 30 June 2023.

Ban on use of ESG terminology – non-labelled products and retail investors

Second, firms that provide in-scope products to **retail investors** where those products do not use a sustainability label (through choice or because the product does not qualify) will be banned from using certain terms in the naming or marketing of that product. These include terms such as "ESG", "climate", "sustainable" or "sustainability", "green", "net zero", "impact", "Paris-aligned" or, for good measure, any other term which implies that a sustainability product has sustainability characteristic.

7. Distributors

Application

The consultation includes some rules specifically applicable to in-scope firms that distribute in-scope products to **retail investors.**

Broadly, where the product has a label, the distributor must display the label prominently on a relevant digital medium and provide access to the relevant customer-facing disclosures. Where the product does not use a label, the distributor will nonetheless be required to provide retail investors with access to the consumer-facing disclosure.

06

Update on Panel Consultation Paper on presumptions of the definition of "acting in concert"

Clare Gaskell (Simpson Thacher & Bartlett)

06 Update on Panel Consultation Paper on presumptions of the definition of "acting in concert"

In May 2022 the Code Committee of the Takeover Panel published a public consultation paper ("PCP") on the presumptions of the definition of "acting in concert" and related matters. The PCP sets out a number of proposed amendments to these presumptions which are intended to ensure they reflect properly both changes in the nature of investment markets since they were first introduced and the current practice of the Panel.

Summary of proposed amendments

If effected, the amendments would:

- increase the threshold for the presumption of concertedness from 20% to 30%;
- make clear that this applies both to voting rights (which will not "dilute" through a chain of ownership – i.e., an entity that controls 30% or more of the voting rights at each level of ownership down to another entity will be presumed to control that other entity) and to equity share capital (which will "dilute" through a chain of ownership, such that the level of equity ownership is calculated on a "see-through" basis, unless an entity owns 50% or more of the equity share capital at each level of ownership (in which case it will not dilute));
- apply the presumptions to limited partnerships and other investment funds in the same way as to companies, treating limited partnership interests in a fund as generally analogous to equity share capital in a company;
- make clear that, where a fund is managed by an independent discretionary fund manager, the fund manager (but not the investors in the fund) will, in general, be interested in any securities held by the fund (noting, however, that an investor may still presumed to be acting in concert with the fund if it satisfies the amended presumptions described above);
- specify that investment managers and investment advisers of a bidder or of an investor in a bidder consortium, together with any persons controlling, controlled by or under common control with them, are presumed to be acting in concert with the bidder and (if applicable) that investor; and
- take account not only of shares owned or controlled by a person but also any shares in respect of which it has any long derivative or option positions.

How will the proposed amendments affect private equity?

The application of the presumptions to funds and new presumption regarding investment managers and investment advisers broadly reflect the longstanding practice of the Panel and, as such, are clarificatory rather than evidencing a substantive change in approach.

Portfolio Companies

The amendment in the threshold from 20% to 30% represents welcome recognition that the current

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threshold captures companies that are not controlled or even materially influenced by a shareholder. Overall the changes will – as the Panel expects – reduce the number of other portfolio companies that are caught within the "concert party" of a bidder backed by a PE/VC firm and, therefore, those who need to receive a stop notice (i.e., the notice sent by a PE/VC firm to its portfolio companies once an offer or possible offer is announced requiring such portfolio companies to (amongst other things) not trade in the target's shares).

However, even the amended threshold will capture non-controlled portfolio companies, including, based on the proposal in the PCP, some that have third party controlling shareholders (in such cases, the PCP says the presumption of concertedness is likely to be rebutted, but this will require consultation with the Panel). In addition, the complexity of the rules regarding voting rights and equity share capital, including the approach to "dilution" through the chain of ownership, means that PE/VC firms are faced with the task of reassessing the data available to them and determining on a case-by-case basis whether portfolio companies can be removed from their concert party lists.

LPs / Investors

The proposed amendments include a new note on the definition of "acting in concert" to provide that where a limited partnership or other investment fund invests in a bid vehicle formed for the purpose of making an offer (or in a new fund formed for the purpose of investing, directly or indirectly, in the bid vehicle), that limited partnership or investment fund will be presumed to be acting in concert with the bid vehicle. There is an existing note in the Code which states that where such an investor's investment is: (1) 10% or less of the equity share capital of the bidder, the Panel will normally waive the presumption of concertedness in relation to other parts of that investor's organisations; or (ii) between 10% and 50%, the Panel may be prepared to waive the presumption of concertedness depending on the circumstances, in each case, provided it is satisfied as to the independence of those other parts from the investor. This can result in, for example, parts of the investor that operate behind information barriers and/or its portfolio companies being excluded from the concert party, which is helpful to minimise the need to send stop notices and gather information on shareholdings and dealings. The proposed amendments would decrease the 50% threshold in item 2 above to 30%, purportedly to align with the 30% threshold applicable to the presumption of concertedness but potentially increasing the size of the concert party in respect of minority investors in a bidder consortium.

Under the definition of "acting in concert" as proposed to be amended, an investor in an existing fund which is providing equity financing for an offer will be presumed to be acting in concert with the bidder if it will have a "see-through" indirect interest of 30% or more of the bidder's equity share capital or if it owns more than 50% of the limited partnership interests in a fund which is subscribing for equity share capital in the bidder. Other than increasing the threshold from 20% to 30%, this codifies the existing approach by the Panel, whereby PE/VC firms are required to assess the LPs of the fund(s) participating in the offer to determine whether or not any LPs are over the above thresholds.

Co-investments

Based on the proposed drafting in the PCP, there remains a risk that a wide network of PE/VC firms and portfolio companies could be presumed to be acting in concert with a bidder by virtue of those firms/portfolio companies being co-investors in unrelated businesses. While this is not how we would expect the Panel to apply the presumptions in practice (nor how it has done so in the past), its stated desire is to reduce the need for consultation to clarify the application of the presumptions and it would therefore be helpful if this point were addressed in the final amendments.

The BVCA Legal and Accounting Committee has submitted a response to the Code Committee setting out its views on the above and certain other matters.

Next steps

The consultation period on the proposed amendments closed in September 2022 and the Code Committee is expected to publish a response statement in late 2022, with the final amendments coming into effect approximately two months later.

07

UK limited partnership legislative reform package proposed in the Economic Crime and Corporate Transparency Bill

Ed Hall and Chris Ormond (Goodwin)

07 UK limited partnership legislative reform package proposed in the Economic Crime and Corporate Transparency Bill

The Economic Crime and Corporate Transparency Bill (the Bill) published on 22 September 2022 includes a package of proposed legislative amendments to UK limited partnership (UKLP) law, substantially to tighten registration requirements and improve transparency. One of the overall aims of the Bill is to prevent the use of English and Scottish partnerships (along with companies) for the purposes of economic crime, including fraud, money laundering and terrorist financing. It builds on the Economic Crime (Transparency and Enforcement) Act 2022 that established the new register of overseas entities that hold UK land, launched by Companies House on 1 August 2022.

Following its Second Reading on 13 October, the Bill is currently in its Public Bill Committee stage where comments have been invited to be submitted in writing. The Public Bill Committee is due to report by 24 November 2022, following which the Bill will progress through its remaining legislative stages.

The principles of the transparency measures are not new, having first been mooted in the government's April 2018 reform proposals, subsequently flagged in the December 2018 BEIS press release and the February 2022 Corporate transparency and register reform white paper, and announced as a Bill in the May 2022 Queen's Speech. If enacted, the changes will represent a significant reform of UKLP law, in parallel with reforms to the powers of Companies House and new powers for law enforcement to seize cryptoassets which are the proceeds of crime or associated with money laundering, fraud or other illicit activity.

This article sets out an overview of the key proposals in the Bill on UKLP reform, along with various comments and issues where the BVCA has inputted. We would expect the Bill to proceed at pace, given the current legislative focus on economic crime. GPs using UKLPs in their funds should therefore start to analyse their structures, so that they are prepared (absent any amendments) to comply within the short six-month transitional period set out in the Bill. In particular, gathering the required information to be submitted to Companies House for each partner (including specifics on any individual limited partners), ensuring they have access to a Scottish or English registered office where their principal place of business is not also in the UK and arranging appointments of individual registered officers of GPs.

Requirement for UKLPs to maintain a registered office with a UK connection

There will be a new requirement for a UKLP to have a registered office in its jurisdiction of registration (England, Scotland or Northern Ireland) at an

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"appropriate" address (i.e. someone who delivers documents there can expect that they will come to the attention of someone acting on the UKLP's behalf and where the UKLP can acknowledge delivery). However, a UKLP will have the option to use the address of its authorised corporate service provider (**ACSP**) as its registered office and could therefore still have its principal place of business outside the UK without affecting the UKLP's registration status. As set out below, this requirement is proposed to be used in tandem with a power for the registrar to confirm dissolution of unresponsive UKLPs. The registrar can also change a UKLP's address if it is not considered "appropriate".

Documents may be served on a UKLP by leaving it at or sending it to its registered office. GPs will also have to maintain a registered email address.

The BVCA has raised concerns about the impact that the requirement for a UK registered office will have on the regulatory status of existing and yet to-be-established AIFs. Under current regulatory treatment, a UKLP with a principal place of business outside the UK would be treated as a non-UK AIF. A mandated UK registered office would change this, in that the current regulatory analysis would deem the non-UK AIF to be established in the UK and therefore instead be a UK AIF. The consequent change to the fund's legal and regulatory treatment would be disruptive to existing structures and their investors, and would reduce the flexibility of UKLPs to be structured as non-UK AIFs going forward. A solution that the BVCA has suggested is to remove the Bill's reference to "registered office", whilst retaining both the requirements for a UK address for service and inspection of documents and also maintaining consistency in determination of the AIF establishment. Alternatively this could be dealt with by amending the UK AIFM Regulations and FCA guidance to provide that a UKLP is not a UK AIF simply because it has a UK registered office under the amended legislation. The BVCA is hopeful that the Government will amend the Bill to resolve this issue before it becomes law.

Required information about UKLPs

When applying to register a UKLP, the GP will have to submit specified information about each partner (whether an individual or legal entity) and any changes in that information (including those relating to a proposed partner that occurred after application but before a UKLP is registered). For a partner that is an individual, this includes the person's name/any former names, date of birth, nationality, usual residential address, the part of the UK that the individual is resident (or country or state if outside the UK), and for a GP that is an individual, a service address (this can be the UKLP's registered office). For a partner that is a legal entity, this includes its name, registered or principal office address, service address, legal form of the entity and for a GP, details of any register in which it is entered.

GPs will also be able to use a standard system of classification to specify the nature of the partnership business.

Delivery of documents by ACSPs

The Bill proposes that all registration applications (as well as confirmation statements, applications for administrative revival and notices of changes) will have to be presented by a registered ACSP, being an entity supervised under UK AML rules. In practice this means applications, where not made by FCA-regulated investment firms themselves, will have to be made by company service providers, law firms and other advisers that are appropriately supervised under UK money laundering regulations and offer this service.

Secondary regulations can make provision for non-UK ACSPs (subject to relevant regulation and supervision in their jurisdiction), which is helpful, as well as to specify other documents to be added to this list and provide any exemptions.

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Restrictions on and requirements for GPs

A GP that is a legal entity will have to appoint an individual as its "registered officer" and provide individual contacts for each of its officers that are also legal entities. Specified information is to be provided for registered officers (based on that for individual partners set out above) and named contacts (being name, usual residential address and an email address).

As currently drafted, the changes may pose an issue for English limited partnerships (**ELPs**) with a UK LLP as their general partner (as is common). As GP of the ELP, the LLP will need to give details of an individual who is its "registered officer" (so a natural person will need to be a member in the LLP). It is standard in a fund structure for a GP LLP to only have two corporate members, so the changes would mean appointing a natural person as a member of the GP LLP, and considering the tax impact of such an appointment.

In addition, a person who has been disqualified as a director of a UK company will not be permitted to be a GP.

Where a GP is appointed subsequent to initial registration of the UKLP, it cannot take part in management until the notification has been made.

Annual confirmation statements and additional filing obligations

As is already the case for certain UK companies, LLPs and Scottish limited partnerships (**SLPs**), ELPs will have to provide an annual confirmation statement to Companies House within 14 days of each review period, to confirm that all the information on the register is correct, and deliver any necessary updates. For existing ELPs, the first review period is between registration and the end of the proposed six month transitional period. For new ELPs, this will be 12 months from their date of registration, then each subsequent 12 month period (which can be shortened on notice to the registrar from the GP). Further rules may be introduced to extend the confirmation statement provisions for SLPs in line with those proposed in the Bill for ELPs.

However, this annual confirmation statement does not replace the current ad hoc Form LP6 filing requirements for notice of changes, with slightly different requirements remaining in place for private fund limited partnerships (**PFLPs**). Given the increase in the amount of information to be submitted to Companies House and that it is proposed that this be also subject to ad hoc and annual updating requirements, UKLPs will want to put rigorous systems in place to ensure they can comply. See also our comments below on potential criminal liability for compliance offences.

Power for HMRC to obtain partnership accounts (for those UKLPs that are not qualifying partnerships)

Although there is no new requirement for compulsory publication of partnership accounts, the Bill proposes giving HMRC the power to obtain UKLP accounts on written notice. This may therefore apply to those partnerships that aren't "qualifying partnerships" under partnership accounting rules. Secondary legislation is to follow on how this is to be implemented and it would be helpful if this followed other example regulations in respect of when this could be requested, i.e. if there is reason to believe that the UKLP may have undertaken fraudulent activity or HMRC receives a request from a law enforcement body.

Where UKLPs are already required to provide accounts under law or regulation, it would be practical and useful if the government confirms that these accounts will suffice. The BVCA will continue to engage with policymakers on these points.

07 UK limited partnership legislative reform package proposed in the Economic Crime and Corporate Transparency Bill

More flexibility in dissolution of UKLPs

These provisions are based on the modifications applied to PFLPs when introduced in April 2017, extended to all UKLPs under the draft amendments. In essence, if a UKLP is dissolved when there is at least one GP, the GP(s) can wind it up, subject to agreement between the partners. If a UKLP is dissolved when there is no GP, the limited partners at that time can, subject to any other agreement between them, appoint someone between them (not a limited partner itself) to wind up the UKLP. This will not comprise management so a limited partner would not lose its limited liability status in appointing someone to wind up the UKLP. An additional proposed amendment is that partners must give notice to the registrar in both cases (see below, under Other, for the concerns around this).

Power of registrar to confirm dissolution of UKLPs

The Bill introduces a new power for the registrar to keep the Companies House register up to date by removing UKLPs from it that are not in business or operation. The mechanic proposed is that, where it has reasonable cause to believe that a UKLP is dissolved, the registrar can publish a warning notice inviting representations to the contrary (a copy of which is sent to the UKLP's registered office and the GP). The registrar can publish a dissolution notice after two months have passed, at which point the UKLP will automatically be treated as dissolved.

Importantly, a restoration procedure is included, whereby on application (within a six year period from dissolution) the registrar can revive a UKLP that it dissolved as set out above, provided various conditions are met (e.g. any outstanding fines are paid and the UKLP's records are updated), in which case the UKLP will be treated as having continued in existence as if it had not been dissolved.

Within a six-month transitional period the registrar can publish a dissolution notice as described above without having to first comply with the warning or notification provisions.

Following dissolution, the registrar has the ability to archive partnership information over time. It seems that the government's intention is that the registrar's ability to remove a UKLP from its index of names under s1099 Companies Act 2006 equates to a power to deregister a UKLP (which could arguably turn the partnership into a general partnership with consequent loss of limited liability status for the limited partners). This is a critical concern as it could undermine the usefulness of UKLPs as investment vehicles for institutional investors, especially in situations where the registrar can act unilaterally to deregister a UKLP in the process of winding up. The BVCA is in discussion with BEIS to better understand their legislative intentions and clarify the impact of the operation of deregistration. The BVCA will continue to engage with policymakers and MPs on this issue as the Bill passes through Parliament.

Voluntary deregistration of UKLPs

A UKLP can apply to be removed from the register if all partners agree. Care will need to be taken if this route is chosen, as on publication of the deregistration notice the UKLP will default to being treated as a general partnership – this is expressly provided in the draft legislative amendments.

Impact on existing UKLPs

For many of the proposals, GPs of existing UKLPs have a six-month transitional period from when the Bill is enacted to provide the information to the registrar and any failure to comply (without contrary evidence) is to be treated as reasonable cause for the registrar to dissolve the UKLP without warning. It will therefore be important that GPs of existing UKLPs ensure they provide the necessary information and make the necessary adaptations to their models within this six-month period.

07 UK limited partnership legislative reform package proposed in the Economic Crime and Corporate Transparency Bill

Other

We would flag three other proposals of impact.

- A broad provision giving power for the secretary of state to make regulations which apply company law with modifications to fit the circumstances of limited partnerships (mirroring an existing power for LLPs). This is a far-reaching provision for potential future amendments to align partnership with company law.
- The Bill introduces various criminal sanctions (fines and in some cases prison sentences) for GPs of UKLPs (and the managing officers of GPs that are legal entities) as well as for limited partners for failure to comply with certain requirements. For limited partners this includes failure to notify the registrar of dissolution, restriction on use or disclosure of information by partners and making material misleading, false or deceptive statements to the registrar (without reasonable excuse). Limited partners, as passive investors in UKLP investment vehicles, would not expect to be exposed to potential criminal liability for administrative filing offences (i.e. filing a notice of dissolution) that they could commit inadvertently. The BVCA therefore continues to engage with policymakers and MPs on this issue as the Bill passes through Parliament.
- Certain information is not to be made available for public inspection, including protected date of birth and residential address information, registered email addresses, named contacts and any statements accompanying documents delivered by ACSPs. However, the registrar can disclose under certain circumstances, for example, where the same information is already publicly available or (for certain information relating to individuals) to credit reference agencies. Partners are also restricted from disclosing residential address and date of birth information of other partners.

08

IPEV valuation guidelines update

Jonathan Martin (KPMG)

08 IPEV valuation guidelines update

Following its Covid-19 “special guidance” published in March 2020, IPEV is now set to release the December 2022 update to its Valuation Guidelines. The update coincides with a period of heightening market turbulence and geopolitical instability, making robust fair valuation an increasingly difficult practice.

Given market developments, a focus of the updated Guidelines is on how Environmental, Social and Governance (“ESG”) factors and distressed/dislocated market conditions interplay with fair value considerations, with an ESG-specific section added to the Guidelines. A section on governance has also been added, reflecting the importance of this topic to the valuations process. Other updates reflect incremental tweaks due to market practice rather than an overhaul of the previous guidance.

On the proposed amendments:

- The Guidelines continue to be principles-based. We noted in our feedback that it is possible that users would value a more illustrative approach to the Guidelines, especially in periods of market volatility.
- The new ESG section highlights the focus given to this area by stakeholders and a high-level framework is included.
- The need for triangulation and more complex valuation techniques (particularly in the early-stage investment space), could be costly if third party involvement is required.
- Updates have been made to the sections on surplus assets/excess liabilities, use of contemporaneous data and valuation in distressed or dislocated markets, which is very welcome.
- The new section on “known and knowable” information at the measurement date is also welcomed.
- In our feedback we noted that more guidance on the treatment of more complex financial instruments, such as preferential instruments, would have been helpful.

Environmental, Social and Governance Factors

In the ESG section, reference is made to both qualitative and quantitative ESG factors that may impact fair value, although the guidance remains principles-based and does not go into detail on how these factors practically affect valuation calculations.

We expect valuers will need to commit time to fully understanding not just measurable aspects of ESG but also more intangible elements that could impact valuation. Consideration will then have to be made, depending on the valuation methodology used, on how these factors could translate into a “point of difference” to comparable transactions or traded companies.

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Increased guidance on the "Allocation of Enterprise Value"

The updates provide some additional considerations for potential surplus asset/excess liability adjustments to the enterprise value – an important aspect of the valuation waterfall. Whilst helpful, the guidance still remains silent on the subject of asset/liabilities specifically within SPVs/investment structures.

The update adds further clarity on the treatment of debt depending on repayment circumstances in a hypothetical sale. Whilst common practice has been to deduct debt at its par value with little further thought when determining an equity instrument's fair value, the update confirms that if debt would not be repaid in a sale scenario, then further considerations should made. Particular attention should be paid to favourable/unfavourable terms that suggest par value of the debt is not the appropriate outcome when calculating the debt adjustment. This an area that will likely require additional attention from valuers.

Known or knowable

The concept of what is known or knowable to the valuer as at the measurement date continues to be a challenging area. For traded shares, the equation is simple, the price is provided as at the measurement date with any movements subsequent to that date considered to not be known and knowable. For unlisted instruments, what is known or, more specifically, what is knowable is less easy to define. The time lag between measurement date and preparation of a valuation can make it difficult to distinguish whether circumstances that have arisen post-measurement date were knowable at that date. The guidance attempts to quantify this by stating known or knowable information would be that available through "routine inspection or due diligence".

Under the current guidance, a hypothetical example of an investment that goes through a rapid sales process post the measurement date, and is sold for a price significantly different to its valuation, could be argued as being neither known or knowable and therefore completely discounted. Whilst IPEV has identified this as a concept that required additional guidance, there is still work to be done to further clarify this position and therefore ensure consistency across valuation approaches.

The guidance is clear however on its updated stance on use of contemporaneous information. Where previous iterations had stressed the importance of up-to-date information being used, the most recent update softens the view on this. The guidance now states that if there is not expected to be significant deviations between reported earnings at, for example, 31 March and the measurement date of 30 June, then it would be acceptable to use the 31 March earnings in the 30 June fair value calculations. This update will be welcome news to valuers who use data, often on a 3-month lag, due to improved visibility, likewise for fund of fund valuers where the valued investment fund has a non-coterminous year end.

Quoted Investments

IPEV has taken the opportunity to recertify two key positions on the valuation of quoted securities:

- That regardless of market dislocation or significant volatility, actively traded securities should be valued at P * Q (closing price on the relevant exchange at the measurement date multiplied by the quantity of shares held). This is despite the belief that in volatile markets, valuers may no longer deem the "share price" to be representative of fair value.
- Discounts can be considered in instances where restrictions are deemed to be attributable to the security, however holder-specific restrictions are not deemed sufficient to deviate from a valuation at P * Q.

The recent June 2022 FASB Topic 820 Accounting Standards update clarifies that contractual sale restrictions (holder specific e.g. underwriter imposed lock up) should

not be considered when calculating fair value whilst regulatory restrictions (security specific) should be considered. This provides a degree of comfort that the IPEV Guidelines, IFRS and US GAAP are now converging on the approach to listed securities, which was seen in practice.

Whilst the Guidelines remain clear that in an active market, quoted instruments are expected to be valued at P * Q, there is still limited guidance as to how to proceed if a market is not deemed to be active.

Valuing seed, start-up and early-stage investments

This section of the guidance has been rewritten but the sentiment remains largely the same. The guidance now stresses the importance of assessing performance post the most recent financing event rather than reverting to implied value per that previous funding round. A useful list of potential qualitative factors to consider to assess current performance of early stage investments is now included.

Complexity arises in IPEV's recommended steps if fair value is deemed to have deviated since the previous funding event. Three possible techniques are highlighted, probability weighted expected return method ("PWERM"), current value method ("CVM") and option pricing method ("OPM"), with the latter being the prioritised technique. Application of these more complex valuation techniques may be difficult to perform without external expertise as the guidance remains principles-based (i.e. with no illustrative examples).

The section remains silent on complex financial instruments such as those with a preferential right attached that can be commonplace, particularly in less mature investments. Further clarification on valuing these types of instrument would be a welcome addition.

Distressed or dislocated markets

This section has been overhauled given the experiences gained through the Covid-19 pandemic and the recent global market volatility. The addition of areas of focus in periods of high volatility will be helpful to valuers. It is likely that valuers will need to commit more time to assessing their valuation inputs particularly around earnings maintainability where market conditions could significantly impact revenue streams, supply chains and operations.

Critically, the Guidelines state that "Fair value is determined using the market conditions which exist on the measurement date". This is a topical area given the time it can take for market shocks priced into quoted instruments to translate into the valuation of private assets. Similar to the removal of the marketability discount (a discount to reflect the time that would be required to sell an asset) in previous iterations of the Guidelines, the current update cements the idea that an asset should be valued using the prevailing information at the measurement date.

Conclusion

The IPEV Valuation Guidelines continue to be principles-based and the recent amendments factor in market experience, including of the wider adoption of the AICPA guidance from the US in 2018 (which is more detailed).

Whilst the changes are helpful, some valuers may want to see more guidance in certain areas such as ESG. However, we should remember that these Guidelines aim to be compliant with IFRS and US GAAP.

Whilst not technically applicable until periods starting after 1 January 2023, there is much in the update that will help practitioners and could easily be applied for the forthcoming December year end valuations, particularly given the cost of living crisis in the UK and its effect on businesses, as well as global challenges and market volatility.

09

Case law update

Jonny Myers (Clifford Chance)

09 Case law update

Dividend clawbacks – UK Supreme Court rules on directors' duty to consider the interests of creditors

The Supreme Court in *BTI 2014 LLC v Sequana SA and others [2022] UKSC 25* has now confirmed that directors of an insolvent or potentially insolvent company owe a duty to take the interests of creditors into account, and that this may intrude upon or override section 172 of the Companies Act 2006 (the duty to act in a way that the directors consider would be most likely to promote the success of the company for the benefit of its members as a whole).

The Supreme Court confirmed that the "creditor duty" is owed to the company, rather than to individual creditors. It is now clear that creditors' interests become paramount when there is no longer "light at the end of the tunnel" and an insolvent administration or liquidation is inevitable. Directors also need to consider the interests of creditors where a company's solvency is uncertain, even if creditor interests do not wholly override shareholders. The greater the company's financial difficulties, the more the directors should prioritise creditors' interests. Where the interests of shareholders and creditors may differ, directors must consider whether shareholders or creditors have more "skin in the game".

The "creditor duty" requires proper consideration to be given to whether to pay a dividend which would otherwise comply with the requirements for a dividend under the Companies Act 2006.

Summary of the case

In *BTI 2014 LLC v Sequana SA [2022] UKSC 25*, an English company that had (by way of a number of complex corporate transactions) inherited a contingent liability for historic river pollution declared two dividends (one in December 2008 and the other in May 2009, totalling EUR578m) to its parent company and sole shareholder, Sequana, before the liability had itself materialised.

The dividends were challenged by AWA, the company to whom it was said the directors who had authorised the dividends owed duties, and BTI 2014 LLC was set up as a corporate vehicle for this challenge.

In summary, the Supreme Court found that the directors were not required to consider, or to act in accordance with, the interests of creditors when paying the dividends in question. The company did not become subject to an insolvency process until some 10 years after the dividend had been paid, and insolvency was not inevitable at the time.

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Is there a duty to consider the interests of creditors?

There isn't a separate "creditor duty"; rather there is a common law rule which in certain circumstances modifies the s.172 duty so that creditors' interests must also be taken into account (creditors are not listed in s.172(1) as one of the factors that directors must have regard to, but the common law rule is expressly preserved by s.172(3) CA 2006).

When does this duty arise?

The Supreme Court held that the duty is triggered when directors know, or ought to know, that the company is actually insolvent or bordering on insolvency, or that an insolvent liquidation or administration proceeding is probable, emphasising that the duty would arise where insolvency was imminent and rejecting the Court of Appeal's test that the duty is triggered when it becomes more likely than not that at some point in the future the company would become either cash flow or balance sheet insolvent.

How should directors exercise this duty?

Unless an insolvent liquidation or administration is inevitable (when the interests of creditors become paramount), where a company is facing a potential insolvency the directors should consider the interests of creditors and balance them against the interests of shareholders where they may conflict. The greater the company's financial difficulties, the more the directors should prioritise the interests of creditors.

High Court rules on liability of beneficial owner for breaches of warranty and whether restrictive covenants were reasonable

In *Ivy Technology Ltd v Martin [2022] EWHC 1218 (Comm)* the High Court held that the beneficial owner of 50% of the shares purchased pursuant to a sale and purchase agreement ("**SPA**") was not liable for any claims for breach of warranty under the SPA, on the basis that he was not a party to the SPA and the contracting seller did not conclude the SPA as agent for him. Henshaw J observed that had the SPA simply failed to mention the beneficial owner, on the factual matrix (including the purchaser's knowledge that the beneficial owner preferred his interest to remain hidden, that the purchaser (subjectively) considered they were buying shares from both owners and that the contracting seller had made clear to the purchaser that the beneficial owner's approval was needed of whatever agreement the contracting seller made relating to the sale) it would have been possible to conclude that he was nonetheless a disclosed and identified principal whose rights and obligations were not excluded by the terms of the contract. However, the recitals to the SPA set out as an agreed basis of contracting that the contracting seller was selling as 100% beneficial owner of the sale shares and that no other person had any interest in them, which was further reinforced by a customary provision in the SPA excluding third party rights and obligations. The High Court found that the admissible factual matrix indicated that the parties to the SPA knew that, unless anything had changed by the time the SPA was signed, the statements in the recitals did not reflect the actual position and that this was an example of parties agreeing to contract on a particular basis whether it be true or not.

The High Court also held that, in its claim for breach of restrictive covenant, the purchaser had not discharged the burden of showing that the relevant non-compete covenant was reasonable.

Henshaw J observed that certain objections made by the sellers to the non-compete covenant did raise serious concerns, namely:

- the absence of any limitation on the seniority of employees or consultants, nor any requirement that they hold any confidential information, nor any requirement that the seller need even have known them or had any contact with them to which the prohibition on solicitation or hiring applied;
- the application of the prohibition on solicitation or hiring to any employee or consultant of the target companies or the purchaser at any date during the currency of the covenant (so that such individual could have been recruited after the date of the SPA); and
- that the two-year period of the restraint ran from the end of a third earn-out period (i.e., five years from completion).

The High Court found that each of these aspects of the covenant was a serious imposition that would require specific justification, and that whilst it was possible that the covenant could have been saved by radical blue-pencilling (subject to potential issues about whether such changes would involve a major change to the effect of the covenant), it was not the function of the court to seek to rescue a covenant (or parts of it) in ways which have not been put forward by the party relying on the clause, the purchaser having failed to address any of these issues either in evidence or in terms of potential narrowing of the covenant pursuant to the blue-pencil principle (or the contractual equivalent incorporated into the covenant itself).

High Court rules on whether there were "manifest errors" in an expert's valuation

In *Re Delilah Cosmetics, White v Nicholson [2022] EWHC (Ch) 1104* the High Court was asked to consider whether an expert's written valuation report of the market price of the defendant's shares in a company contained any "manifest errors" such that the written valuation was not final and binding on the claimants and defendant in accordance with a shareholders' agreement ("**SHA**").

The defendant wanted to sell her shares in a company also owned by the claimants. The SHA provided an agreed mechanism for a share valuation and sale at the "current market price". Pursuant to the SHA, the parties appointed an expert, a chartered accountant, whose determination as to the value of the shares was to be final and binding on the parties, 'in the absence of manifest error or fraud'. The expert valued the defendant's shares at £1.00. This was challenged by the defendant by reference to four classes of "manifest error".

In the leading decision of *Veba Oil Supply & Trading GmbH v Petrotrade Inc [2001] EWCA Civ 1832* (Court of Appeal), manifest error was described by Simon Brown LJ as "oversights and blunders so obvious and obviously capable of affecting the determination as to admit of no difference of opinion". In Delilah, Chief ICC Judge Briggs noted, based on Veba Oil and other authorities, that the test for manifest error is two stage and exacting: a manifest error must be established and must further be shown to have caused a material difference to the result.

In this case the judge concluded that no manifest errors had been made, as none of the errors brought forward were established to be both a manifest error and to have caused a material difference to the result of the valuation of the defendant's shares. Therefore, the judge declared the expert's valuation report to be final and binding on the parties and ordered specific performance of the SHA.

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