British
Private Equity &
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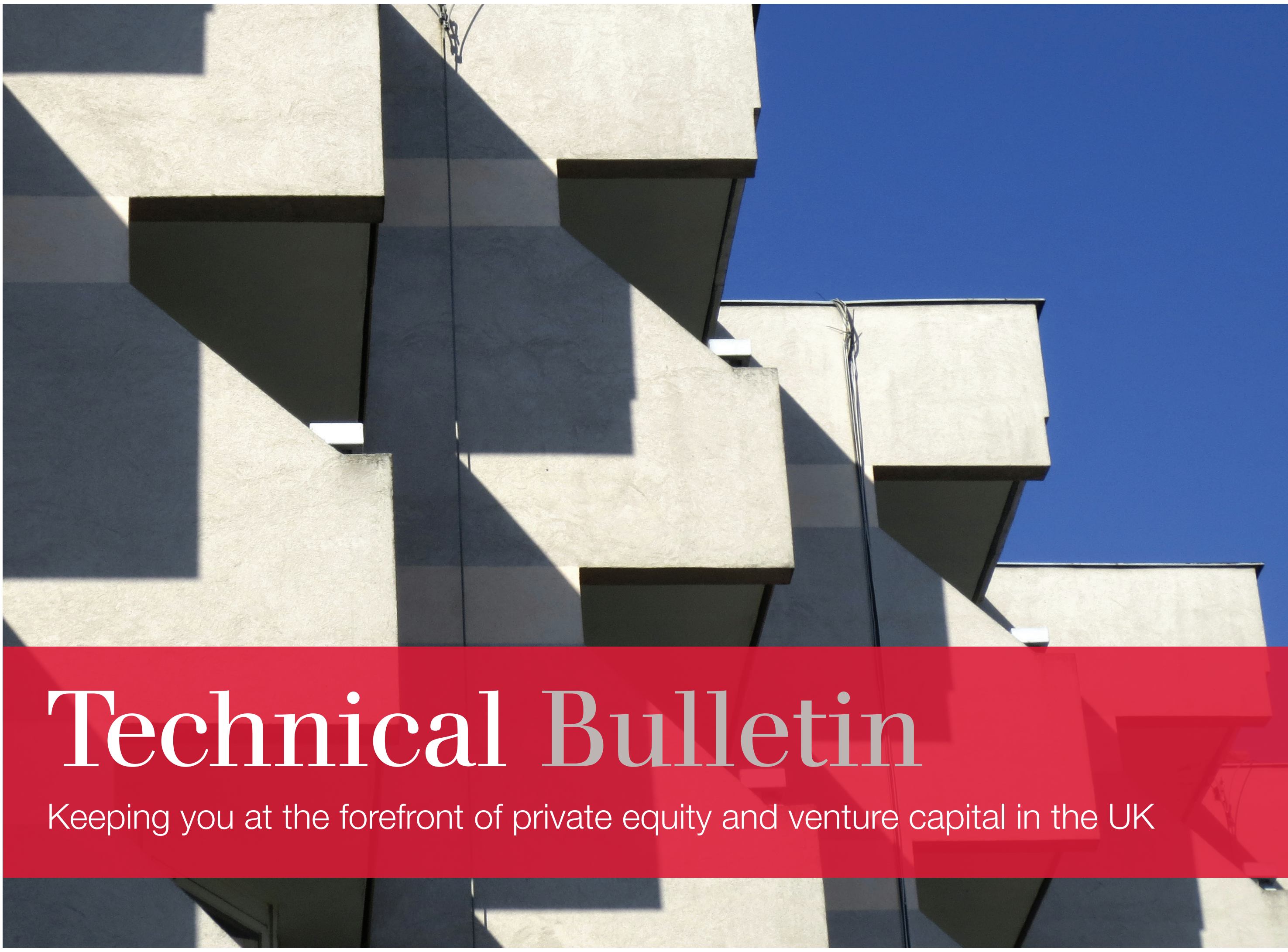
Association



Technical Bulletin

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

November 2016

Introduction

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Chair
Legal & Accounting Committee

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

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

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

The biggest development by far is the vote to leave the European Union in June and the impact this will have on the UK's future relationship with the EU. Whilst the outcome has not had a direct effect from a technical perspective, it will invariably influence discussions on upcoming EU legislation and dominate our agenda for years to come. The decision brings with it a period of uncertainty for our members and the businesses in which they invest. The implications of Brexit for the private equity and venture capital industry and the BVCA's response is covered in the opening article by the BVCA's Director of Policy, Gurpreet Manku.

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The Regulatory Committee has been reviewing particular issues surrounding Brexit, including the potential introduction of a third country passport under AIFMD. Stephanie Biggs and Tim Lewis examine this in their article, which addresses whether third country passporting rights under AIFMD really are the solution for non-EU fund managers aiming to access EU investors. Stephen Robinson explores another key piece of forthcoming EU regulation that will impact the industry, the Packaged Retail and Insurance-based Investment Products Regulation that will require a key information document to be prepared for retail investors. On matters not covered in detail in this Bulletin, the committee responded to the Government's action plan for anti-money laundering and counter-terrorist finance[1] and consultation on the implementation of the fourth money laundering directive[2]. The committee also met with the FCA, which incorporated our feedback into their new return (REP-CRIM) for reporting on financial crime.

Our renamed Legal and Accounting Committee has been busy responding to a number of legal developments including, alongside our US and European counterparts, the Financial Stability Board's proposed policy recommendations to address structural vulnerabilities from asset management activities, specifically leverage in funds[3]. The committee also published amendments to the standard confidentiality agreement for use in buyout investments (originally produced in 2014), along with a back-to-back agreement for lenders and advisers[4]. In her article, Amy Mahon looks at the particulars of the persons of significant control register and the implications for UK incorporated companies since the legislation was enacted in April 2016, including how to manage the impact of this legislation more generally on transactions.

In the case law update, Jonathan Wood provides an overview of English court judgements issued in the past six months. This includes case studies of High Court and Appeal Court decisions on the implied duty of good faith, the illegality defence in civil claims, and the potential binding nature of letters of commitment. Another longstanding agenda item for the committee is EU audit reform, the requirements and impact of which have been detailed in an update by Iain Bannatyne.

The ongoing OECD BEPS process has a been particular focus for the Taxation Committee, who have responded to a range of consultations over the past two years including those covering transfer pricing, hybrid instruments, interest deductibility and treaty abuse. The focus of the last article by Alexander Cox is the BEPS Action Point 4 on interest deductibility. He details the consultations from the HMT and HMRC and how the OECD's best practice recommendations should be incorporated into the UK tax system.

The Taxation Committee has also been responding to various consultations from HMRC and HMT, including proposals to tackle disguised remuneration[5], reforms to corporation tax loss relief[6] and the reform of substantial shareholding exemption provisions from capital gains tax[7]. The committee is monitoring developments in the area of agreements on exchange of information with a view to tackling tax evasion such as FATCA, the Crown Dependencies and Overseas Territories rules and the OECD's Common Reporting Standard (CRS). They have also been working with HMRC on the implementation of CRS and have updated our model documents[8] to help meet the requirements.

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[1] http://www.bvca.co.uk/Portals/0/library/Files/Regulatory/160602%20BVCA%20Response%20to%20Action%20Plan%20for%20anti-money%20laundering%20and%20counter-terrorist%20finance.pdf

[2] http://www.bvca.co.uk/Portals/0/library/documents/Government%20Submissions/161114%20Consultation%20on%20Transposition%20of%204MLD.pdf

[3] http://www.investmentcouncil.org/app/uploads/09-21-16-aic-invest-europe-comment-letter-to-the-fsb-on-asset-management-activities.pdf?dm_t=0,0,0,0,0

[4] http://www.bvca.co.uk/ResearchPublications/Publications/StandardIndustryDocumentsandGuidance/ConfidentialityAgreementFormforbuyouts.aspx

[5] http://www.bvca.co.uk/Portals/0/library/documents/Government%20Submissions/161005%20BVCA%20response%20to%20consultation%20on%20tackling%20disguised%20remuneration.pdf

[6] http://www.bvca.co.uk/Portals/0/library/Files/Government%20Submissions/160818%20BVCA%20response%20to%20HMRC%20reforms%20to%20corporation%20tax%20loss%20relief.pdf

[7] http://www.bvca.co.uk/Portals/0/library/Files/Government%20Submissions/160818%20BVCA%20response%20to%20HMT%20on%20reform%20of%20the%20SSE.pdf

[8] http://www.bvca.co.uk/ResearchPublications/Publications/FATCAandCRSModelDocuments.aspx

Our committee members

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

We would like to thank all members that have served on the technical committees, including those who have recently stepped down, for their considerable contributions. In particular, we would like to thank Simon Witney who stepped down from the Legal and Accounting Committee following the end of his second term as chair. Simon was a longstanding committee member and his extensive experience and sheer dedication has been immensely valuable to us. We would also like to welcome new members to our committees.

	New members on our committees	Members who stepped down
Legal & Accounting Committee	Ashley Coups (EY) Ed Hall (KWM)	Simon Witney (KWM) Alison Hampton (Hg Capital) Godfrey Davies (CDC) Steve Parkinson (EY)
Regulatory Committee	Babett Carrier (Cinven) Andrew Lewis (ICG)	Alice Nisbet (LDC) Paul Gunner (Bridgepoint) Amy Veitch (Macquarie) Amandeep Johal (Triton) Ida Levine (Capital International) Oliver Morris (KPMG)
Taxation Committee	Bill Shaul (KPMG) John Cox (KPMG) Russell Warren (Travers Smith)	James Markham (Graphite Capital) Marius Draghici (Carlyle) Kathleen Russ (Travers Smith)

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

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

With best wishes,

Amy Mahon
Chair, Legal & Accounting Committee

David Nicolson
Chair, Taxation Committee

Sheenagh Egan
Chair, Regulatory Committee

Gurpreet Manku
Director of Policy, BVCA

Legal & Accounting Committee	Regulatory Committee	Taxation Committee
Amy Mahon (Chair) *Clifford Chance*	Sheenagh Egan (Chair) *Livingbridge*	David Nicolson (Chair) *Bridgepoint*
Julie Bradshaw (Vice Chair) *Doughty Hanson*	Andrew Lewis *ICG*	Abigayil Chandra *Deloitte*
Alastair Richardson *3i*	Babett Carrier *Cinven*	Adam Frais *BDO*
Ashley Coups *EY*	Christopher Crozier *Permira*	Alexander Cox *Ashurst*
David Higgins *Freshfields Bruckhaus Deringer*	Ed Kingsbury *Dechert*	Alexandra Hone *ICG*
Duncan Tennant *Permira Advisers*	Fidelis Wangata *Pantheon Ventures*	Anthony Stewart *Clifford Chance*
Ed Griffiths *DLA Piper*	James Smethurst *Freshfields Bruckhaus Deringer*	Clare Copeland *European Capital*
Garrath Marshall *Deloitte*	John Decesare *3i*	Craig Vickery *Exponent PE*
Geoff Bailhache *Blackstone*	Louise Dumican *Carlyle*	Dominic Spiri *Terra Firma*
Geoff Kittredge *Debevoise & Plimpton*	Mark Howard *KKR*	Fiona Cooper *Starwood*
Graham Hislop *Montagu*	Rachel Thompson *Bridgepoint*	Gareth Miles *Slaughter and May*
Iain Bannatyne *KPMG*	Simon Powell *Advent International*	Graham Iversen *Greenberg Traurig*
John Atherton *Adveq Management*	Stephen Robinson *Macfarlanes*	Jenny Wheater *Linklaters*
John Heard *Abingworth*	Tim Lewis *Travers Smith*	Jill Palmer *3i*
Jonathan Wood *Weil, Gotshal & Manges*	Secondee: Sam Bishop *Travers Smith*	John Cox *KPMG*
Richard Mcguire *PwC*		Jonathan Page *PwC*
Robin Bailey *Pantheon Ventures*		Maria Carradice *Mayfair Equity Partners*
Sally Roberts *Accel*		Mark Baldwin *Macfarlanes*
Stephanie Biggs *Travers Smith*		Matthew Saronson *Debevoise & Plimpton*
Trudy Cooke *Terra Firma*		Michael McCotter *Doughty Hanson*
Thomas Laverty *Kirkland & Ellis*		Paul Cunningham *Helios Investment Partners*
Secondee: Tamsin Collins *Clifford Chance*		Paul Warn *EY*
		Richard Vitou *Deloitte*
		Russell Warren *Travers Smith*
		Sarah Priestley *Formerly with Shearman & Sterling*
		Stephen Pevsner *KWM*
		Tim Hughes *PwC*
		Secondee: Jonathan G Hurd *EY*

1. Brexit and the BVCA

Gurpreet Manku

Director of Policy
BVCA

The UK's decision to leave the EU caused shockwaves across the world. Socially, politically and financially, the repercussions will continue to be felt for years, and although the situation is still fluid, the BVCA has been extremely active in ensuring the interests of the UK private equity and venture capital community are represented at the highest levels of the negotiation process.

Our activities

Since the vote to leave the EU, we have been gathering and sharing intelligence and building relationships with a wide range of key stakeholders and organisations to maximise our influence with Government and politicians in a process that remains uncertain and unclear. Broadly, our activities fall into five categories:

- Engagement with the key stakeholders in Government, such as the newly formed Department for Exiting the European Union, HMT, MPs on relevant committees and the FCA.
- Participation in the City Investors Roundtable, initially established by the Department for Business, Innovation and Skills - now superseded by the Department for Business, Energy & Industrial Strategy – and the Treasury after the referendum, but before Theresa May became Prime Minister.
- A series of Brexit Breakfasts to assess member sentiment. These have been and are continuing to take place in London, Manchester, Birmingham, Bristol, Leeds and Edinburgh.
- A Brexit Taskforce has been formed comprised of our policy team, the chairs of our three technical committees and representatives across the different parts of our membership.
- Ipsos-Mori was commissioned to conduct a second survey of portfolio company chief executives on the economic outlook and Brexit priorities (see more below).

Areas for consideration

At the risk of understatement, for the Government, leaving the EU will be a very complicated process. From the point of view of private equity and venture capital specifically, but also business and investment more widely, there are seven sets of issues which it will need to consider:

- The UK's legal separation from the EU.
- A free trade agreement of some form with the EU.
- Any interim arrangements that may be required between departure from the EU and a free trade agreement coming in to place.
- The UK's full independent accession to the World Trade Organisation.
- New UK-specific trade agreements to replace current deals between the EU and 53 states.
- New UK trade agreements with nations that do not presently have treaties with the EU.
- Co-operation with the EU on foreign, defence and security matters.

Over the summer, Brexit discussions within Whitehall started to evolve. The two most important are clearly (a) when and how to trigger Article 50, which is the subject of a legal challenge that could potentially impact the Government's desired timetable (by the end of the first quarter 2017), and (b) the argument between a relatively 'soft' Brexit (which would see the UK retain considerable links to the institutions of the EU) and a comparatively 'hard' Brexit (with more autonomy). The latter point in particular will steer the policy and technical discussions as we head into the negotiation process.

However, the sheer scale of the task ahead, and the implications it will have on the private equity and venture capital industry, means that we need to establish our key priorities and asks before these negotiations begin. To this end, we have developed a work plan and have started to map out the key priorities during the negotiation process, and steps the Government could take to boost the competitiveness of the UK.

Our priorities include the ability of our members to:

- Raise funds from EU investors.
- Negotiate and do deals in the EU (as well as other ongoing involvement in portfolio companies).
- Retain existing portfolio company acquisition structures in the EU and service them.

The base case for planning purposes is that the UK becomes a third country on exit with no special rights of access. We are currently going through the process of collating information – via a membership survey – on how our members are regulated, the passports they use (if any) and their fund structures. This will further support our assessment of the potential impact of Brexit from a technical perspective.

The UK has not officially left the EU and so the current legal and regulatory framework we have in place continues to apply to our member firms. The FCA has made it clear that it still expects firms to continue to abide by their obligations under UK law, including that derived by EU law. Furthermore, this includes firms' implementation plans for legislation that is still to come into effect.

The relevant EU directives for fund managers and advisers in the private equity and venture capital industry are the Alternative Investment Fund Managers Directive ("AIFMD") and the Markets in Financial Instruments Directive ("MiFID"). A number of managers have also registered under the European Venture Capital Regulation ("EuVECA"). Whilst we are fortunate we are not in the midst of implementing an EU file as substantial as the AIFMD, firms will need to continue to navigate the implementation of MiFID II, the Market Abuse Regulation, PRIIPs and the Fourth Anti Money Laundering Directive. The timing of the UK's withdrawal will also fall within the period in which AIFMD is reviewed (currently scheduled for the second half of 2017). We will of course continue to work on this, but it is unclear how the timetable and process for amending the directive will be impacted by Brexit.

Key priorities for the industry

People – access to talent and certainty for the existing workforce

In common with many other parts of the UK economy, one of the challenges for private equity and venture capital firms, and the companies they invest in, is finding requisite skills on the ground. Attracting highly-skilled workers and entrepreneurs to the UK, as well as allowing high-growth companies to find the skilled employees that they need and at suitable speed to make the most of their market opportunity, is an urgent priority. This includes confirming that EU nationals who are in work here already can stay to provide business with the certainty it needs.

Funding for the venture capital and growth funds industry

Between 2011 and 2015 the European Investment Fund ("EIF") directly invested €2.3 billion of investment into the UK venture capital and growth funds industry. As the EIF acts as a cornerstone investor in many venture capital funds – drawing more private capital in – this figure under-represents its true value to the UK. Overall, the EIF estimates that, between 2011 and 2015, it has mobilised a total of €13.8 billion of investment into the UK venture capital and growth funds industry.

Analysis by the EIF shows that between 1996 and 2014 start-ups in London attracted more EIF-backed investment than any other city in Europe, while start-ups in Cambridge attracted the third most EIF backed investment of any European city. It is essential for UK start-up and SME financing that EIF funding is either preserved or secured through a UK body after the UK exits the EU. We have created a working group that is looking specifically into this area and will be reaching out to members.

Access to investors in the EU

The UK private equity and venture capital industry requires and encourages cross-border investment with the rest of the EU ("rEU"). Over the past three years, 18% of funds raised by the industry were raised from rEU countries (in 2015 this figure was 26%). With respect to investment activity, over the past three years 40% of funds invested into companies by the industry were invested in companies based in the rEU (in 2015 this number was 42%). A loss of access to the European market would therefore have a substantial impact on the ability of the UK industry to raise funds and in turn direct them towards the most attractive investment opportunities. This could reduce the amount of investment available to businesses to the detriment of both the UK and Europe.

A key priority is therefore to ensure our members still have access to EU investors. There are different ways in which this could be achieved, depending upon the regulatory position of the fund manager. The rules facing firms from a marketing perspective are already complex as Member States have the right to set their own national private placement regimes ("NPPRs") and a number of managers, particularly non-EU and sub-threshold AIFMD firms utilise EU Member States' NPPRs. There is a growing appreciation within the UK's financial services industry of the complexities associated with obtaining access to the EU's single market through passporting and equivalence regimes. The next article by Tim Lewis and Stephanie Biggs at Travers Smith sets out how the AIFMD third country passport was intended to operate and the challenges entailed. Its implementation has been delayed in part because of the political sensitivities associated with Brexit, although officially the Commission's work on assessing third country jurisdictions' approach to anti-money laundering and countering tax avoidance is still in progress.

Under the AIFMD, if the third country passport does become available for non-EU managers, the Commission could decide that in the future NPPRs should no longer exist, meaning that the only way to access EU investors is via the AIFMD passport and this will be costly and prohibitive for smaller managers. Well-functioning European NPPRs are essential to maintaining global capital flows and must be preserved even once a third country passport is available, to provide fund managers and investors with flexibility e.g. if the EU investor base is small in relation to the size of the fund. This is a point that has been made on several occasions by the BVCA and Invest Europe as part of the industry's representations on the European Commission's Capital Markets Union project (in relation to initiatives to reduce cross border barriers to investment and the distribution of funds), as well as consultations on the implementation of the third country passport under AIFMD.

Continued ability to provide investment advice across the EU

A number of private equity groups have firms that are regulated under MiFID II. The UK being granted equivalence under this directive is a financial services industry ask, but it may not provide the certainty firms need, not least because the equivalence determination may not be made by the time we leave the EU and it can be revoked at any time.

Transitional arrangements to address the cliff edge effect

There is expected to be a period of time between the day the UK leaves the EU and the agreement of a bilateral trade deal with the rEU. Therefore, a sensible transitional arrangement between the UK and the rEU needs to be in place to avoid cliff edge scenarios on Brexit day. For example, without a deal in place, a UK-based fund manager that is partway through raising funds from EU investors using a marketing passport, would have to cease its activities, leading to significant business disruption.

There is growing momentum on this point in particular and calls for the UK Government to signal early on in the negotiation process that this is core to their strategy. A transition period will not only benefit UK firms, but also provide certainty to EU investors, clients and businesses.

Tax matters

Our members benefit from certain exemptions under EU directives such as from withholding tax on dividends under the Parent-Subsidiary Directive. There are issues in relation to certain investments which rely on the Directive and for which the double tax treaty network may be inapplicable or not achieve an optimal result. This area is being reviewed further by the tax committee.

Portfolio companies

We are also assessing the impact on portfolio companies. Given the wide range of sectors in which our members invest, our starting point is to establish private equity and venture capital-specific issues at a transactional level and then other ongoing matters that affect all portfolio companies.

As well as the impact on fund managers, we have been collating feedback from the businesses in which our members invest. Before the vote, in March 2016, we published the results of a survey of 200 key decision-makers conducted by Ipsos MORI. At the time, 83% of business leaders of companies backed by private equity and venture capital believed that remaining in the EU would be best for their business, while 78% felt Brexit would have a negative impact on the overall economy.

Ipsos MORI carried out a second survey following the EU referendum result, again interviewing 200 key decision makers at portfolio companies (many of which participated in our first survey). The results were published in October 2016 and found that economic confidence has fallen significantly since the previous survey from March. Forty percent of respondents now believe economic conditions have worsened over the past 12 months and 45% think they will get worse, an increase of 30 percentage points for both statements. There is a resilient optimism over their own prospects; 63% say that business has improved over the last 12 months – down a modest six percentage points – and 70% believe it will get better in the coming year – a decrease of 14 percentage points. Innovation and product launches were the most likely reasons for improvement.

The UK as a global hub for private equity and venture capital

The success of the UK as a leading destination for venture capital and private equity firms has been driven by our ability to attract talented individuals who work within the firms themselves as well as the underlying portfolio companies in which the industry invests. Over the past few years, a number of complex and fundamental changes to legislation have been introduced in the UK.

Brexit also brings an opportunity for the UK to improve its standing and competitiveness in the international venture capital and private equity industry. Our policy framework must encourage inward investment and attract the best talent. Central to achieving these goals is a robust and competitive domestic regime that brings the stability and predictability that businesses and our industry needs to make long term investment decisions.

Alongside our efforts to ensure a smooth transition as the UK leaves the EU, the BVCA will assess how our domestic legislation should operate in a post-Brexit environment.

Keeping members briefed

To keep our members briefed over what will be an extended period of uncertainty and potential change, we will continue with our breakfast series and supplement this with political analysis offered by BVCA Insight and Friday Focus publications, alongside further information on tax, legal and regulatory aspects through our monthly Technical Updates. We have also set up a Brexit hub on our website[9] where members can get access to our latest updates.

[9] http://www.bvca.co.uk/NewsPublicPolicy/BrexitandtheBVCA.aspx

2. AIFMD Third Country Passport: Not a Silver Bullet?

Tim Lewis

Travers Smith

Stephanie Biggs

Travers Smith

Since the Brexit vote, "passporting rights" have become something of a buzzword in the media, but are third country passporting rights under AIFMD really a silver bullet enabling non-EU fund managers to access EU investors? There are a number of reasons why the AIFMD third country passport – in its current form – may not be as useful as it first appears.

The basic principle underpinning AIFMD is that fund managers should be able to access EU investors only if those managers are regulated to EU standards. The ability of non-EU sponsors to market under national private placement regimes ("NPPRs") was only ever intended to be a stopgap; AIFMD contemplates that all NPPRs will be withdrawn three years after the third country passport becomes available.

The timeline for introducing the third country passport has slipped significantly from the original target of Q3 2015. This is primarily because of the difficulties faced by ESMA in assessing whether key non-EU jurisdictions should be eligible for the passport (which they are evaluating on a country-by-country basis), and it is reasonable to suppose that the political complexities of the UK becoming a third country at Brexit may lead to further delay. So, it may be a while before the third country passport becomes a reality – but how useful will it be when it finally arrives?

There are a number of pre-conditions to accessing the third country passport as a non-EU manager:

- The non-EU manager must be authorised and regulated by an EU regulator – even if the firm is already regulated by its own regulator (e.g. the U.S. SEC or, post-Brexit, the UK FCA) in a jurisdiction assessed as eligible for the passport.
- Once authorised, the non-EU manager must comply with AIFMD in full, on the same basis as an EU manager. This includes, for example, the requirement to maintain regulatory capital and to comply with the AIFMD remuneration regime. The only exception is where there is a direct conflict between the AIFMD requirements and the rules to which the manager is subject in its home jurisdiction and it is impossible to comply with both sets of rules.
- The non-EU manager must have a legal representative established in the EU member state in which it is authorised. The legal representative acts as a local contact point for the EU regulator and for EU investors, and must perform the AIFMD compliance function in respect of EU fund management and marketing activities. It seems likely that third party service providers will offer this as an outsourced service but this requirement will, at a minimum, impose additional cost and administrative complexity.
- Investor disputes must be settled in accordance with the law of, and subject to the jurisdiction of, an EU member state. It is not yet wholly clear whether this means that the fund agreement and subscription documents for funds offered to EU investors must be governed by the laws of an EU jurisdiction, but there is a risk that some EU regulators will take that view.

In addition, the non-EU manager is not free to choose which EU regulator it wants to be authorised by; authorisation must be obtained in the non-EU manager's "member state of reference" (MSR). AIFMD sets out in detail the basis on which a firm's MSR is to be determined, with a dispute resolution mechanism if EU regulators disagree between themselves as to which regulator should have oversight of a particular firm.

For a non-EU manager marketing multiple funds, including at least some non-EU funds, to investors in multiple EU jurisdictions, its MSR will be the EU member state in which it intends to develop "effective marketing" for most of those funds. An AIFM can prove its intention to develop effective marketing in a particular member state by disclosure of its marketing strategy. The relevant information includes, as a minimum:

- the member states where marketing will take place (including via placement agents);
- the expected share, by AuM, for each member state, as a proportion of AuM for all member states;
- an estimate of the expected number of investors that will be targeted in each member state;
- the (official EU) language(s) in which the marketing materials will be made available; and
- the distribution of marketing activities across the EU taking into account the prominence and frequency of advertisements/road shows.

There may be relatively little that a firm can do to achieve the MSR of its choice. Some factors that may enable a non-EU manager to influence the determination include:

- having an affiliate in the preferred MSR that can act as the non-EU manager's legal representative, especially if some of the investor relations team are based in, and marketing to EU investors from, that office;
- translating marketing materials into the official language of the preferred MSR, if that is not English;
- if possible:
  - approaching more prospective investors (by number and, if possible, by anticipated AuM) in the preferred MSR than in other member states; and
  - holding more marketing meetings in the proposed MSR than in other member states, but these may still not be enough to override the practical reality that – by and large – prospective investors are located where prospective investors are located.

Brexit complicates the issue further. Absent Brexit, many non-EU managers would have been relatively comfortable with the UK FCA as a regulator and it would have been relatively easy to demonstrate effective marketing in the UK given the size of the UK investor base. If the UK is outside the single market following Brexit, the UK FCA will not be an available option. There may then be a mismatch between firms' preferred EU regulator (perhaps the Central Bank of Ireland or the Luxembourg CSSF, owing to their familiarity with regulating fund managers and funds) and the jurisdictions in which most of the firm's EU investors are based. It remains to be seen how actively, or otherwise, EU regulators will scrutinise or challenge a firm's initial determination.

The BVCA has been working closely with Invest Europe to ensure that EU legislators are aware of the potential issues with the AIFMD third country passport as currently proposed, in the hope that some improvements can be achieved when AIFMD is reviewed, if not before. In the meantime, EU investors will need to remain alive to the potential difficulties for non-EU managers in accessing the EU market, and may need to act on their own initiative if they want to ensure continued access to non-EU funds.

3. Why managers of private equity and venture capital funds should be aware of the PRIIPs Regulation

Stephen Robinson

Macfarlanes

Many private equity and venture capital managers (“Managers”) may have overlooked the forthcoming EU PRIIP Regulation (the “Regulation”) assuming that, because they do not generally raise money from retail investors, the Regulation is not relevant to them. However, the definition of “retail investors” for these purposes is unexpectedly broad, meaning the Regulation will apply where Managers raise money for their funds from high net worth or sophisticated investors, from local authorities or from their “friends and family”. It may also apply in relation to staff co-investment and/or carried interest arrangements.

What is a PRIIP?

PRIIPs (Packaged Retail and Insurance-based Investment Products) include any investment where the amount payable to a retail investor is subject to fluctuations due to the performance of assets which are not directly purchased by the retail investor. This is a wide-ranging definition that will therefore cover all types of private equity and venture capital funds, as well as investment trusts and venture capital trusts.

What is the aim of the Regulation?

The main purpose of the Regulation is to help retail investors better understand and compare key features, risks, rewards and costs of PRIIPs by proving them with a uniform three-page standard key information document (“KID”) prior to investment.

To whom does the Regulation apply?

The Regulation applies to PRIIPs manufacturers and also to those distributing PRIIPs. It will therefore apply to Managers and also potentially to placement agents engaged by Managers to assist with fundraisings.

When does it apply?

The Regulation only applies to PRIIPs that are “made available” to retail investors. This phrase is undefined in the Regulation. The logical conclusion is that if any retail investor can subscribe for an interest in the PRIIP, it has been made available to retail investors.

What is a retail investor?

The definition of “retail investor” encompasses anyone who is not a professional client as defined in MiFID. Under MiFID, investors that are not automatically considered “per se professional clients” must meet certain requirements set out in two tests (a qualitative test and a quantitative test) in order to elect to be able to be treated as “elective professional clients”, and not as retail investors.

The qualitative test

Managers will be familiar with the qualitative test as this is the test used by them to “opt up” their executives and “friends and family” to elective professional client status. This is the only “opt up” test which needs to be met in such circumstances because operating a private equity or venture capital fund is non-MiFID business. Under the qualitative test, the Manager must undertake an adequate assessment of the expertise, experience and knowledge of the individual that gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the individual is capable of making his/her own investment decisions and understanding the risks involved. Certain disclosures must also be provided. It is generally a fairly straightforward test for a Manager to operate.

The quantitative test

For the purposes of the Regulation (which follows the MiFID tests), the qualitative test alone is not enough. Investors must also meet a more onerous quantitative test, by satisfying at least two of the following criteria:

i) the investor has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters *(very few, if any, investors in private equity and venture capital funds will be investing in 40 funds per annum)*;

ii) the size of the investor's financial investment portfolio, cash deposits and financial instruments, exceeds EUR 500,000 *(a number of investors will likely meet this test)*; and

iii) the investor works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged *(this test will likely be met by some of the Manager's investment staff but friends, family, high net worth investors and sophisticated investors will not necessarily have worked in the private equity or venture capital industry)*.

As it can be harder to meet the quantitative test, a greater number than expected of investors in private equity and venture capital funds will likely be considered retail investors for the purposes of the Regulation. As such, Managers may well be in the position of marketing to investors that meet the qualitative test and that can therefore be considered "elective professional clients" for the purposes of being eligible to invest in the fund, but that nonetheless will be considered retail investors for the purposes of the Regulation because they do not meet the quantitative test.

What if staff members are the only retail investors in my funds?

Funds "dedicated to institutional investors" are excluded from the scope of the Regulation. As such, if the only retail investors for Regulation purposes are staff members, it is likely that no KID will need to be produced (although there has, as yet, been no regulatory confirmation of this approach and advice should be sought on a case-by-case basis). If there are any external retail investors (e.g. "friends and family" or other high net worth or sophisticated investors), the Regulation will apply.

My fund is established in the Cayman Islands or Channel Islands. Do I need to worry?

Yes. If a fund is made available to retail investors anywhere in the EEA, then the Regulation will apply.

If the Regulation applies, what next?

The Manager is responsible for producing a KID. The KID should be:

i) a maximum of three sides in length (A4 size);

ii) in the standardised form and with content as set out in the Regulations;

iii) provided to investors free of charge;

iv) provided to an investor in good time before they invest;

v) available to investors on a website or in hard copy; and

vi) should be referred to in marketing communications such as the PPM.

If KIDs are required, a firm will need to produce a template KID and then set up appropriate operational infrastructure to ensure that relevant data required to be presented is captured and presented in the right way.

Alternatively, there are many outsourced KID providers who can help. Outsourcing KID production will not significantly dilute the infrastructure required as data will still need to be collated and transmitted to the chosen service provider.

The Regulation requires KIDs to be reviewed regularly and revised where necessary to ensure they continue to be up to date. However, the Regulation does not address how this requirement should be applied in the context of closed-ended funds (which are no longer "made available" to investors after their final closing and from which investors typically cannot withdraw or redeem once they have invested). Logic suggests that this requirement should not apply following the final closing of a closed-ended fund (especially as the purpose of the KID is to help retail investors before they take their investment decision), but as yet no regulator has confirmed this interpretation. Where updated KIDs are produced, these should be made available to retail investors promptly; either on the Manager's website or in hard copy.

Do we need to provide KIDs to investors that have already invested in our existing funds?

No. Only to retail investors to whom a fund is made available after the Regulation becomes effective.

What needs to be included in a KID?

The following table sets out the structure and summary of content requirements of a KID:

Section	Detail
1. Title	Key Information Document' should appear prominently at the top of the first page
2. Purpose	A mandatory explanatory statement describing the purpose of the KID
3. Comprehension Alert	*(where applicable)* An alert to investors if the product may be difficult to understand
4. What is this product?	Type, objective, intended investor, details of insurance benefits (if any), term of the PRIIP
5. What are the risks and what could I get in return?	Risk indicator, performance scenarios
6. What happens if the manager is unable to pay out?	Information on whether there is a guarantee scheme e.g. FSCS
7. What are the costs?	Specific details on costs to be borne by the investor
8. How long should I hold it and can I take money out early?	Details including a recommended minimum holding period
9. How can I complain?	How and to whom can a complaint be made
10. Other relevant information	

What are the most challenging parts of the content requirements?

The content requirements look relatively simple; however, there is a significant amount of data to be gathered and a number of calculations to be carried out in order to produce the information in the format required. Some potentially more challenging aspects are:

Performance Scenarios

Past performance is not included in the KID. Future expected performance, i.e. average return per year after costs, should be estimated and presented in three different scenarios (unfavourable, moderate and favourable, determined in each case in accordance with a prescribed methodology), at one year, at half the recommended holding period, and at the recommended holding period. Nine performance calculations are therefore required. The hold period for a private equity or venture capital fund will be the life of the fund.

Costs

All direct and indirect costs incurred by an investor in the fund must be included but they must be presented by their impact on return averaged over the holding period (known as "reduction in yield"). Transaction costs must be included.

Risk Indicator

The Manager will need to assign a "summary risk indicator" to the PRIIP by giving it a number on a scale from 1 (being the lowest risk) and 7 (being the highest risk). The methodology to determine the relevant number is based on onerous market risk and credit risk calculations. It is likely that many private equity and venture capital funds will be assigned a summary risk indicator of 7.

What if the retail investors are outside of the UK?

The KID must be translated into the official language of each EEA country where the PRIIP is distributed or in another language accepted by the regulator of that country.

What if we do not produce KIDs or do not produce them correctly?

Managers failing to produce KIDs will be subject the standard range of regulatory sanctions. In addition, Managers may face damages claims from investors for loss caused by reliance on inaccurate or misleading KIDs.

Interaction with other regimes

Certain elements of the Regulation are not currently aligned with the UCITS Directive key investor information document or the disclosure of costs and charges required by MiFID II. This is unhelpful for managers subject to more than one regime who may need to collate and present data in several different ways in different types of documents in order to comply.

When does the Regulation take effect?

The Regulation was originally intended to apply to firms from 31 December 2016. However, in accordance with the Regulation, the European Commission and the European Supervisory Authorities are required to produce certain regulatory technical standards which, amongst other things, standardise the presentation, content and format of the KID and provide the methodology underpinning the presentation of risk and reward and the calculations of costs (the "RTS"). On 14 September 2016, the European Parliament voted in favour of objecting to the draft RTS, raising concerns over certain aspects of the KID. The European Commission needs to review the points made in the objection and present revised proposals to the European Parliament for approval. Following a few weeks of uncertainty it has now been confirmed by the Commission that the Regulation will now take effect from the start of 2018, to coincide with the implementation of MIFID II.

What next?

We are currently in a period of uncertainty as the industry waits for the European Commission to re-draft and present revised RTS to the European Parliament. However, without the detail of the RTS finalised there will be no standardisation of presentation (one of the main aims of the Regulation).

While we await clarification, Managers should begin analysing their investor base to see if they are likely to need to produce KIDs. If they accept retail investors, they should either revisit their systems and controls to prevent retail investors from being able to invest in their products (if practicable) or should start looking at required content and any systems build needed to be able to collect and present data in a Regulation-compliant manner.

4. The PSC Register: Issues which have arisen in practice

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Summary

Since 6 April 2016, UK incorporated companies (other than certain exempt companies such as DTR 5 issuers) have been required to maintain a register of individuals and legal entities with significant control over them (the "PSC Register") and to make the contents of the register public.

The BVCA Technical Briefing in March 2016 provides a detailed analysis of the scope and requirements of the new PSC Register provisions introduced by The Small Business, Enterprise and Employment Act 2015[10]. This article looks at some of the issues which have arisen in practice in interpreting the PSC Register legislation and how to manage the impact of this legislation on transactions more generally.

Interpretation provisions

There are a number of interpretation issues in relation to the conditions to establish who is a PSC. This article looks at a few of the common issues.

- Condition 1 states that a person is a registrable person ("PSC") if "*the individual holds, directly or indirectly, more than 25% of the company's shares*". If you are required to calculate 25% of the shares when different classes of shares have different nominal values you need to calculate the aggregate nominal value for each share class to determine the aggregate nominal value of all shares in issue.
- Condition 2 is met if a person "*is entitled, directly or indirectly, to exercise (or control the exercise of) more than 25% of the company's voting rights*", which are the rights conferred on shareholders in respect of their shares to vote at general meetings of the company on all or substantially all matters. Treasury shares and shares which do not have voting rights such as preference or deferred shares should not be included in the calculation. In addition, the articles should be checked to see if, for example, there are weighted voting rights.
- Condition 3 is met if a person is "*entitled, directly or indirectly, to appoint or remove a majority of the board*". The wording of this condition is slightly misleading as it is the right to appoint or remove directors holding a majority of voting rights. In working out the voting rights you should review the articles and check the chairman's casting vote.
- Where persons hold a share or right jointly, each of them is treated as holding that share or right. For example, if two individuals have their names jointly recorded on the register of members as holding 40% of shares in a company, each of them will be treated as a holder of 40% of the shares and each will be a PSC.
- Similarly, where joint arrangements exist, where shareholders agree to act jointly in respect of shares or rights, each person will be treated as holding the combined shares or rights of both of them, so each will be a PSC. An arrangement is broadly defined, it can even mean custom and practice, but something does not count as an arrangement unless there is a degree of stability in relation to it.

[9] http://www.bvca.co.uk/Portals/0/library/Files/Legal%20&%20Technical2/160330%20BVCA%20Technical%20briefing%20March%202016%20%E2%80%93%20Introduction%20of%20the%20PSC%20Register.pdf

- Condition 4 is met if a person has the right to exercise "*significant influence or control over the company*". The statutory guidance in relation to this condition contains non-exhaustive examples. However, where you have a Joint Venture (JV) which does not meet the majority stake test, remember that the test it not only majority voting rights and board appointment, but also dominant influence or control. This is also the case when you are looking through a general partner of a limited partnership (which is not an relevant legal entity ("RLE")) to see if anyone has a majority stake in the GP. For example, if each of the shareholders in the GP has an absolute veto right over adopting or amending the company's business plan each shareholder will need to be registered as RLEs under condition 4. (This is unlikely to be common in practice.)

Restriction notices

Companies subject to the PSC Register regime must take reasonable steps to identify any PSC or RLE, in relation to the company. They also have a duty to keep this information up to date. Failure by a company to comply with such obligations is a criminal offence for both the company and every officer of the company who is in default, and can lead to a fine or imprisonment.

If a company has not been informed of a person's status as a registrable PSC or RLE or has not been supplied with all the particulars that it must record in its register, then the company must serve notices on anyone it knows (or has reasonable cause to believe) are its PSCs and/or RLEs (section 790D CA 2006). Similar notice provisions apply where a company knows, or has reasonable cause to believe an individual or legal entity has ceased to be a registrable PSC or RLE or their particulars have changed (section 790E CA 2006).

Recipients of a section 790D or 790E notice must comply within one month. If they fail to do so, a company may give such person a Warning Notice. If the person does not comply with the Warning Notice within one month, (and does not have a valid reason for not responding), the company may issue a Restrictions Notice.

The effect of a Restrictions Notice in relation to a relevant interest is that any transfer of the relevant interest is void, no rights are exercisable in respect of the relevant interest, no shares may be issued or offered in respect of the relevant interest and no dividend or payment may be made in respect of the relevant interest. A person trying to exercise any right to dispose of such a relevant interest commits a criminal offence.

Transaction Issues

In a transaction, if the shares or rights that are proposed to be transferred are subject to a Restrictions Notice, the agreement to transfer is void. To mitigate this risk legal review should be conducted on the PSC registers in the group structure and appropriate enquiries should be made. For example, preliminary enquiries should include a request for a copy of the PSC Register and any restriction notices. In the SPA itself, warranty protection should be provided by the seller about the PSC Register and the seller should agree to comply with the PSC Register regime between signing and completion.

A Restrictions Notice also causes issues with many shareholders' agreements ("SHA") in relation to a UK company. A typical SHA will include provisions that require the transfer between the private equity fund and the manager shareholders of a manager's shares in certain situations, for example drag/tag or put/call or exit/deadlock provisions. The main concern for a shareholder that is party to such a SHA is that a Restrictions Notice could be issued to one of the other shareholders that restricts the transfer of a relevant interest of such shareholder, which would cut across these types of provisions. Where a Restrictions Notice is in place, a shareholder will not be able to enforce the relevant SHA provision against the shareholder with the restricted relevant interest, because the transfer of such interest and any agreement to transfer such interest is void. It is therefore advisable to include wording ensuring the manager shareholders comply with the PSC Register regime or ensuring the general compliance obligations cover it.

In addition, if a Restrictions Notice is issued to a shareholder with respect to a relevant interest, no shares may be issued in respect of the interest or in pursuance of an offer made to the interest-holder. This may cause implications where the company is seeking further financing from its shareholders by way of a share issue. A shareholder with a restricted relevant interest would not be able to take part in the offer and therefore the other shareholders would have to provide further financing through the equity offer (although they would be increasing their stake in the company).

Implications for banking transactions

Security agents and lenders generally fall outside being an entity with "significant control" in the PSC Register Regime. The legislation contains a specific carve out for rights attached to shares held by way of security where, except from exercising them to preserve the value of the security or realise it, the rights are only exercisable in the chargor's interests. The statutory guidance also provides carve-outs such that lenders under an LMA type of facilities agreement would not ordinarily fall within condition 4. A Restrictions Notice has potential implications for banking transactions where there is security over shares and a Restrictions Notice has been issued to the chargor in respect of those shares. Such a Restrictions Notice could affect whether the security can be given, whether the security can be enforced and whether voting rights can be exercised. The issue of a Restrictions Notice is discretionary and when considering whether to issue such notice, the company is required to take into account its effect on the rights of third parties in respect of the relevant interest, which could potentially include the rights of the security agent as holder of the security over the shares.

Future changes

HM Treasury launched a consultation on the Fourth Money Laundering Directive (the "Directive"), including a section on Article 30 of the Directive, which requires member states to use a central register to hold information on beneficial ownership for corporate and other legal entities incorporated within their territory. That consultation closed on 10 November 2016. In parallel, the Department for Business, Energy & Industrial Strategy ("BEIS") has recently published a discussion paper on the transposition of Article 30 of the Directive.

Article 30 of the Directive

Whilst the PSC Register Regime is consistent with a number of requirements of the Directive, BEIS is considering extending the list of entities which are required to register information on beneficial ownership within the PSC Register Regime to include, amongst others, Scottish limited partnerships, Scottish partnerships, unregistered companies and open-ended investment companies. In addition, in order that the information remains "current", BEIS is considering how often PSC information needs to be filed at Companies House.

The consultation closes on 16 December 2016 and the Directive must be implemented by member states by 26 June 2017 (although the European Commission has published a proposal to move the transposition date forward to 1 January 2017).

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5. Case Law round-up

Validity of notice of claim for breach of warranty

In its decision in *Teoco UK Ltd v Aircom Jersey 4 Ltd*, the High Court struck out claims for breach of warranty on the basis that they were not notified in accordance with the notice provisions of a share purchase agreement.

The court considered whether a buyer's warranty claims were barred by a contractual limitation of liability, which required the buyer to give the seller written notice of a claim setting out reasonable details of the claim (including the buyer's good faith estimate of the amount) as soon as reasonably practicable after it became aware of such claim. The buyer relied on two letters to support the validity of its notice, but the court held that these were not sufficient as they: (i) did not identify the warranties which had been breached; and (ii) failed to choose between a claim for breach of warranty and a claim under the tax indemnity. In addition, the first letter did not even refer to the notice of claims clause and the court therefore ruled that a reasonable recipient would not have understood that the letter was a notice of claim under the contract. Moreover, the buyer acted in breach of the notification provision by failing to notify the seller of a claim as soon as reasonably practicable, after becoming aware that it was entitled to bring one.

The decision is a reminder that claims for breach of warranty must follow the applicable contractual notification requirements and, even if the substance of a claim is set out in a notice, the claim may be struck out by a court if the notice is non-compliant with such requirements. The High Court outlined several key principles which are relevant in the context of warranty claim notifications, including:

- every notification clause will turn on its own wording and the courts should focus on the meaning of the relevant words used in their documentary, factual and commercial context;
- the buyer should ensure that the seller knows in sufficiently formal terms that a claim for breach of warranty is to be made. In addition, the notice must specify that a claim is actually being made (and not merely suggest that it may be made);
- in construing a notice of claim, courts should consider whether such notice would be understood by a reasonable recipient with knowledge of the context in which it was sent; and
- as a general rule, identifying the particular warranty that is alleged to have been breached should ordinarily be a minimum requirement when providing "reasonable details" of a claim.

Court of Appeal decision on repudiatory breach of contract

In its decision in *MSC Mediterranean Shipping Company S.A. v Cottonex Anstal*, the Court of Appeal upheld a decision that an innocent party was not entitled to affirm a contract for the purpose of claiming ongoing liquidated damages for delayed performance following the counterparty's repudiatory breach.

The Court recognised that a repudiatory breach of contract does not necessarily lead to a termination of the contract, but rather allows the innocent party to decide whether to terminate or to affirm it. However, in this case the Court found that the innocent party did not have the option of affirming the contract – this was because the defaulting party was unable to perform its contractual obligations (as the commercial purpose of the contract had become frustrated) rather than simply refusing to do so. The decision therefore provides that an innocent party's ability to affirm a contract following a counterparty's repudiatory breach will be restricted if performance is no longer possible.

The Court also disagreed with the suggestion that good faith principles are relevant in considering whether an innocent party has a legitimate interest in affirming a contract. According to the Court, the recognition of a general duty of good faith would be "a significant step in the development of our law of contract with potentially far-reaching consequences". In addition, there is "a real danger" that if a general principle of good faith were established, it would be invoked (equally frequently) to undermine and to support the terms on which the parties have reached agreement.

These comments suggest a reluctance of the senior courts to broaden the application of good faith principles in matters of interpretation and contractual construction, and were followed by the High Court in the case described below.

Implied duty of good faith

The Court of Appeal's stance on the duty of good faith described in the *MSC v Cottonex* case above was affirmed in the High Court's decision in *Monde Petroleum SA v Westernzagros Ltd*. In this case, the High Court rejected an argument that a party's contractual right to terminate a consultancy agreement needed to be exercised in good faith.

The judge commented that, outside of certain accepted categories of contract characterised by a fiduciary relationship (such as employment contracts), a good faith duty will only be implied where the contract would lack commercial or practical coherence without it. The simple fact that a contract was long-term or "relational" was not sufficient to imply such duty.

A distinction was also drawn between implied terms to act in good faith in the performance of a contract and a term dealing with termination. In the latter case, a contractual right to terminate may be exercised irrespective of the reasons for doing so (provided that any relevant contractual conditions are satisfied).

Interpretation of restrictive covenants and boilerplate clauses in share purchase agreement

In its decision in *Millen v Karen Millen Fashions Ltd & Anor*, the High Court considered the meaning and effect of a restrictive covenant given by a share seller, as well as certain boilerplate provisions commonly seen in share purchase agreements.

In its conclusions, the Court noted that:

- The claimant, a seller of shares in the Karen Millen business, was not entitled to declarations that a range of activities, including the use of her first name in any line of business and "Karen Millen" in relation to homewares, would not breach the restrictive covenants she gave in the share purchase agreement.
- A further assurance provision in the agreement was sufficiently broad to require the claimant to give her consent to certain trade mark applications made by the defendants (who were the purchasers of the relevant shares).
- One of the defendants, which acquired its interest in the business after the original purchasers went into administration, was a successor in title within the meaning of an assignment clause and therefore entitled to claim under the agreement.
- The choice of jurisdiction clause in the agreement, though silent on the point, was exclusive in its effect. It bound not only the original contracting parties, but also successors in title and third parties in bringing proceedings against the claimant in a US court alleging breach of the agreement, the defendants had breached the clause.

The decision serves as a useful reminder when negotiating share purchase agreements. In particular, parties should ensure that the scope and effect of the provisions set out above is assessed appropriately, and that any future events are taken into account when drafting the document.

Are warranties also representations?

In the Idemitsu *Kosan Co Ltd v Sumitomo Co Corp* case, the High Court considered whether contractual warranties given by the seller in a share purchase agreement were capable of founding an action for misrepresentation. This case serves as a reminder of the distinction between warranties and representations and highlights the significance of non-reliance wording in an entire agreement clause.

The Court dismissed the buyer's misrepresentation claim through a summary judgment, in which it held that:

- where a contractual provision states only that a party is giving a warranty, that party does not, by concluding the contract, make any statement to the counterparty that is actionable as a misrepresentation;
- while, in principle, language used in the communication of a negotiating position or draft contract may amount to an actionable pre-contractual representation, in this case the contractual warranties contained in the share purchase agreement were not representations of fact;
- it would be wrong to read the warranty schedule in the share purchase agreement as if it evidenced anything more than a willingness to give a certain set of contractual warranties in a concluded contract;
- the seller's prior provision or signature of the execution copy of the share purchase agreement could not give the warranty schedule a different character at that stage than it had when the share purchase agreement was concluded; and
- the entire agreement clause in the agreement also defeats the buyer's claim as, the buyer expressly agreed and acknowledged that it had not relied on or been induced to enter into the agreement by any representations or warranties, other than the contractual warranties set out in the agreement.

Court of Appeal confirms exclusion clauses should be construed narrowly where necessary to resolve ambiguity

In its decision in *Nobahar - Cookson & Ors v The Hut Group Ltd*, the Court of Appeal confirmed that, if necessary to resolve ambiguity, exclusion clauses should be resolved by adopting the narrowest of several possible interpretations. The rationale is that parties cannot be taken to have lightly reduced remedies which the law allows for breach of contractual obligations, unless the contract contains clear words to that effect.

Whilst this has similar effect to the traditional *contra proferentem rule* (which states that that where a contractual provision is ambiguous and there is doubt about its meaning, the words will be construed against the party who is seeking to rely on it), the Court of Appeal rejected this concept in this instance, stating that its decision has nothing to do with the identification of the party putting forward the clause or seeking to rely upon it.

Illegality defence in civil claims

In the *Patel v Mirza* case, the Supreme Court ruled that illegality will not always be a defence to a civil claim. This is an important decision because it challenges a well-established principle of English law that courts will not enforce illegal bargains.

In brief, the facts of the case are that one man lent another man £620,000 to buy shares on the basis of insider knowledge and the shares were ultimately not purchased. The Court ruled that the lender was entitled to claim his money back – just because a party had provided funds to another for committing an illegal act, did not necessarily mean that the lending party was not entitled to recover its funds in circumstances where they had not been used for the illegal act. The Court held that, while there is a public interest in not undermining the integrity of the criminal justice system, the civil courts should not impose additional penalties, disproportionate to the nature and seriousness of the wrongdoing in question.

The decision sets out a framework approach in relation to the illegality defence, pursuant to which the courts will consider the following factors:

- the underlying purpose of the law which has been breached by the conduct, and whether that purpose is enhanced by denying the relevant civil claim;
- the impact on public policy if the relevant claim is denied; and
- whether denying the claim is a proportionate response to the illegality, bearing in mind that any punishment should be applied by criminal, not civil, courts.

Relevant factors can include seriousness of the conduct, its importance to the contract, whether it was intentional and whether there was any marked difference in the parties' respective culpability. The Court also considered that in some cases, denial of a claim could give the other party (who may in certain cases, such as this one, be equally blameworthy) a substantial and unjust reward.

Potential binding nature of letters of commitment

The decision of the High Court in *Novus Aviation Limited v Alubaf Arab International Bank BSC(c)*, serves as a warning to parties who are entering into documents which are not intended to be legally binding. The Court found that a letter of commitment (dealing with the bank's provision of funding to Novus to finance the acquisition of an airplane) was an enforceable contract and the bank's withdrawal from its terms constituted a breach of contract, even though the letter was expressed to be "conditional upon satisfactory review and completion of documentation" and was only signed by one of the parties.

The Court concluded that, whilst the commitment letter provided for a signature on behalf of Novus to indicate acceptance of its terms, there was no provision in the letter which stipulated that such signature was the only means of acceptance. Therefore, acceptance could be communicated by conduct, which objectively shows an intention to accept the offer (a similar approach was taken by the Court of Appeal in the recent *Reveille Independent LLC v Anotech International (UK) Ltd* case) and, as Novus proceeded with the steps required to progress the transaction and gave no indication that it did not consent to the terms of the letter, the Court ruled that such conduct had occurred. In addition, the bank did nothing to suggest that it was waiting for Novus's countersignature or that it did not regard the letter as binding until countersigned.

The Court also accepted that it is possible, in principle, for parties to create a document of which only part is intended to be legally binding. However, where that is the intention, the distinction between binding and non-binding provisions should be very clearly signalled. In this case, obligation-type obligation was used throughout the commitment letter, with a number of terms including the mandatory words "shall" and "covenant" – the Court found that these were sufficient to establish an intention to create legal relations.

The commitment letter stated that the bank's obligation to provide funding to Novus was "conditional upon satisfactory review and completion of documentation for the purchase, lease and financing". The bank argued that the letter was void for uncertainty as there were no objective criteria by which to judge whether the documentation was satisfactory. The Court disagreed – whether the documentation was satisfactory to the bank was a question of fact. Further, the bank's ability to reject the documentation as unsatisfactory was not completely unqualified, but in the nature of a contractual discretion. In the absence of very clear language to the contrary, such discretion must be exercised in good faith for the purpose which it was conferred, and must not be exercised arbitrarily, capriciously or unreasonably.

This case demonstrates that, in order to reduce the risk of inadvertently creating binding obligations, parties should bear in mind the following points:

- if a document (or certain of its provisions) is not intended to create legal relations, this should be expressly stated;
- where a contractual obligation is conditional upon the exercise of discretion by a party, that discretion must be exercised in good faith for the purpose which it was conferred, and must not be exercised arbitrarily, capriciously or unreasonably;
- if it is intended that a document should only become binding upon countersignature, that requirement needs to be expressly stated within the document. Absent such express requirement, acceptance of an offer may be communicated by conduct or other communication between the parties; and
- even if there is an express requirement for countersignature, it is possible for that requirement to be waived by clear words or conduct. Accordingly, parties should be careful with proceeding with the underlying transaction prior to countersignature by the other party. Including an express stipulation in the document that its terms may only be waived in writing is also important in this context.

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

The Technical Bulletin issued in May 2016 considered the potential impact on the private equity industry of the implementation measures introduced by the EU which reform the way EU companies can engage with their auditors. The EU audit directive and regulation come into effect on 17 June 2016.

Urgent questions…

The measures are now substantially effective and there are now two urgent questions which private equity firms must consider:

- Firstly, do they have any EU based public interest entities ("PIEs") in their portfolio? Our previous bulletin covered the definition of a PIE in detail, but this is essentially an EU company which has either equity or debt securities are listed on a regulated EU market. PIEs will be restricted in both the quantum and nature of non-audit services which can be provided by their auditor.
- Secondly, does any EU PIE have an EU-domiciled parent company, since the non-audit restriction will apply to both the PIE itself and also any EU parent company (as well as any controlled undertakings of the PIE).

In considering the second question, the legal structure associated with each PIE will need to be carefully assessed and there are two likely scenarios where an EU parent might be identified:

- Certain private equity structures involve the use of master holding companies which are frequently domiciled in Luxembourg. Where this master holding company is the parent of an EU PIE then the auditor of that EU PIE will not be able to engage with the Luxembourg company on an unrestricted basis and the PE firm should consider with the EU PIE auditors the impact of this restriction.
- Where the General Partner of the fund is located in the EU, then the private equity firm will need to assess whether the GP also falls to be defined as the parent of the fund and any EU PIEs.

Is the GP the parent of the portfolio company?

Our previous bulletin discussed how the question of whether a GP of a PE fund is a parent undertaking is a complex and fact-specific area, and generally dependent upon the level of control exercised over the fund.

We recommend that members liaise with their fund auditors to evaluate their circumstances to determine whether the GP is considered the parent.

How does the investment advisor fit into the GP legal structure?

Most private equity firms also have an investment advisor, which may be a member of the same legal group as the GP, or may be a separate legal entity in a different legal group [without a holding company/subsidiary or group relationship], albeit with many common shareholders. An assessment of whether the investment advisor is in a control relationship with an EU PIE should be carried out.

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

7. BEPS Action Point 4: Interest Deductibility

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Background

The OECD's final report on Action Plan 4 seeking to limit the use of interest and other financial payments to shift profits out of high tax jurisdictions into no or low tax jurisdictions was published in October 2015.

Since then HM Treasury and HMRC have conducted two consultations on how, and to what extent, the OECD's best practice recommendation should be incorporated into the UK tax system. The second was published in May this year and contained detailed proposals on policy design and implementation. The BVCA has responded on both of these consultations and those responses are available on the BVCA website[11].

Key features

The key features of the latest proposals, which broadly follow the OECD's best practice recommendation, can be summarised as follows:

Fixed Ratio Rule	Corporation tax deductions limited to 30 per cent of tax EBITDA.
De minimis	No restriction on net interest expense below £2m.
Group exception	Net interest expense deductible up to a level equal to the world-wide group's net interest / EBITDA ratio, if this is higher than the fixed ratio, save that interest arising on related party debt, or which would not ordinarily attract interest relief in the UK, will be excluded from the group net interest calculation.
Modified Debt Cap	Corporation tax deductions for net interest expense limited to worldwide group's net interest expense.
Carry forward of restricted interest	Restricted interest (e.g., in excess of fixed ratio) can be carried forward indefinitely and will be deductible in subsequent period.
Carry forward of spare capacity	Spare capacity can be carried forward for 3 years.
No carry back	
Transitional Provisions	Unlikely, save in exceptional circumstances.
Infrastructure	Limited exception for certain public benefit projects.
Banking and Insurance sectors	Proposals to follow.
Targeted rules	Targeted anti-avoidance provisions.

It is proposed that the new rules will take effect from **1 April 2017**.

[11] http://www.bvca.co.uk/NewsPublicPolicy/Policy/GovernmentSubmissions.aspx

Application to private equity

For an industry which has historically used leverage to finance the acquisition and development of businesses in the UK and elsewhere, the proposals are particularly relevant and the extent to which interest and other financing costs will remain deductible on third party debt and shareholder loans is obviously critical, both in terms of existing arrangements and future financings. As will be seen from the summary below, the absence of any meaningful transitional provisions means that existing arrangements need to be considered very carefully and the group exception will be particularly important for businesses whose net interest costs exceed the 30 per cent ratio or the £2m de minimis. While the proposals are not yet fully formed (and the detail is only likely to appear in draft legislation following the Autumn Statement), it is possible to make a number of observations on how the rules might reasonably be expected to apply in this area.

Fixed Ratio Rule

In brief, the fixed ratio rule will limit the deductibility of a group's UK net interest expense to 30 per cent of the group's tax adjusted UK EBITDA.

For these purposes:

- a group is generally expected to constitute the consolidated group for accounting purposes and to stop at the top corporate entity in the group. Where the group is owned by a limited partnership or a group of individuals, the group should not include the limited partnership or individuals. Nor should master holding companies be included if they account for their investments in portfolio companies at fair value;
- the group's UK net interest expense will be the amount by which the external interest costs of all the UK companies (and any UK permanent establishments) in the group exceed their external interest income. A UK holding company set up by a fund to acquire a non-UK target with back to back financing through the UK company should not therefore be affected by the rules because its interest income should exceed its taxable profits and gains (and corresponding losses) and will therefore differ from accounting EBITDA;
- interest income and expense will include all financing costs on loans, e.g., arrangement fees, discounts, premia and so on; and
- tax adjusted EBITDA will broadly include only taxable and allowable income, profits and gains (and will therefore differ from accounting EBITDA).

De minimis

There will be no restriction under the new rules if the UK net interest expense of the group is less than £2m p.a. This broadly equates to the following amounts of debt at the following interest rates (ignoring arrangement fees, which would increase the effective financing cost):

Annual Interest	Interest Rate	Loan Amount
2m	4%	50m
2m	5%	40m
2m	6%	33.3m
2m	7%	28.6m

To the extent that net interest exceeds £2m, it is expected that only the excess will be subject to restriction under the fixed ratio rule to avoid a cliff-edge for businesses around the £2m threshold.

Group exception

The group exception is intended to ensure that the deductibility of genuine third party interest costs is not affected by the fixed ratio rule, recognising that some businesses may have higher levels of external gearing. It attempts to achieve this by allowing businesses to claim deductions for net interest expenses at a ratio equal to the worldwide group's net interest to EBITDA ratio, if this is in excess of 30 per cent.

There are, however, three important (and potentially anomalous) aspects to the current proposal which may mean that it does not achieve what appears to be the underlying policy objective in every case.

Tax EBITDA and Group EBITDA

As set out above, the fixed ratio rule will operate by reference to tax adjusted EBITDA. EBITDA for the purposes of the group ratio test, however, will be based on accounting EBITDA. The two tests do not therefore operate on a like for like basis and there is a significant risk that deductions for financing costs on genuine third party debt could be restricted, even in the context of a solely UK group, in circumstances where accounting EBITDA is greater than tax adjusted EBITDA. It could also lead to volatility as accounting EBITDA and tax adjusted EBITDA vary from year to year.

Effect of non-UK operations

The group ratio rule, as currently proposed, produces some particularly anomalous results where there are non-UK operations in the group. An illustrative example of this is included at the end of this note. The May consultation paper identified, but did not address, potential anomalies where group EBITDA is low in comparison to group interest costs, but does not address specifically the effects of increases and decreases in non-UK operations on group EBITDA. As is evident from the example, the current proposal leads to the rather odd possibility that the deductibility of external financing costs could be restricted if, by virtue of the performance of non-UK operations, group EBITDA improves but could be increased if, on the same basis, group EBITDA falls.

The BVCA has suggested that one potential solution to this would be to allow businesses to elect to peg interest deductions by reference to the group interest to EBITDA ratio day 1, which should in practice reflect the worldwide borrowing capacity of the group at that time. That election would apply for so long as there were no material changes to the financing arrangements of the group and, while in these circumstances the relevant business would be protected from future restrictions, similarly it would not benefit from any increased interest capacity over that period.

Qualifying interest and related party debt

In the calculation of a group's net interest expense, it will be necessary to exclude interest which would not ordinarily attract interest relief in the UK (e.g. profit participating debt) and, most importantly for private equity, interest on related party debt.

The related party definition is extremely broad, including not only parties which have control over or a 25 per cent plus interest in another entity but also parties acting together to secure control or a 25 per cent plus interest, e.g. club or consortium deals. It is therefore fair to assume that interest on shareholder loans in a private equity context will not generally count towards (and increase) the group's net interest expense and deductions will not be available for such interest costs under the group exception accordingly. (It is important to note that this denial is only relevant for the purposes of the group exception and so interest costs on shareholder loans will remain deductible on general principles to the extent that they fall within the 30 per cent fixed ratio or £2m de minimis.)

The BVCA has made representations on the related party restrictions generally, but it looks almost inevitable that they will be included in some form and parties should prepare accordingly.

Modified debt cap

It is unlikely that the introduction of the new proposals will result in a wider repeal of other interest restrictions within the UK tax system. Even the worldwide debt cap will continue in a modified form, although, in the current proposals, this should only be relevant in the context of the fixed ratio rule (principally to stop groups loading interest costs into the UK up to the 30 per cent limit).

No grandfathering

The current proposals contain no meaningful transitional provisions into the new regime and, despite representations, discussions with HMT and HMRC suggest that this position is unlikely to change. Existing financing arrangements will generally therefore be within the scope of the rules and any attendant restriction on the deductibility of interest costs may feel particularly harsh where those interest costs have, quite reasonably, been assumed to be deductible because they relate to third party debt or have been the subject of an Advance Thin Capitalisation Agreement with HMRC. Additional tax costs may also put businesses at risk of breaching the financial covenants in their financing documents.

Interaction with loss reform

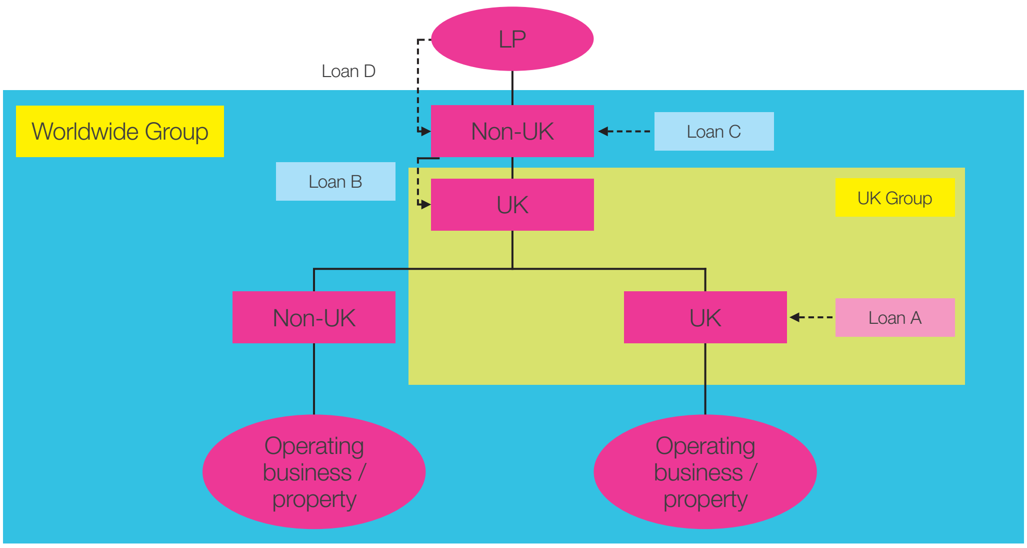
The one welcome proposal in the May consultation paper is that interest restricted under the new rules should be carried forward and, subject to available capacity in subsequent periods, be treated as if it had accrued in those periods so that it is not subject to both the interest restriction and the 50 per cent restriction on carry forward losses proposed as part of the reform of the UK's corporate loss relief system – yet another consultation.

The BVCA has suggested that businesses should also be able to carry forward any interest costs which would have been restricted under the fixed ratio rule but for the £2m de minimis, otherwise the de minimis inadvertently imposes a second restriction on interest expenses – particularly relevant for businesses in the development phase.

Conclusion

It will be clear from the summary above that the consequences of the latest proposals may be significant for UK businesses. It is true that the fixed ratio rule proposed reflects similar restrictions already in place in other major European jurisdictions but the absence of any meaningful transitional provisions, in particular, means that businesses will have to adapt quickly if the Government sticks to the current timetable and introduces the new rules with effect from 1 April 2017. More detail is expected in the Autumn Statement, which is taking place on the date this Bulletin is published. An update will follow in the next edition.

Example



	Year 1	Year 2
UK EBITDA	1000	1000
Group EBITDA	1600	2400
Interest Cost		
- Loan A	250	250
- Loan B	150	150
- Loan C	350	350
- Loan D	200	200
Net UK Interest Expense	400	400
Net Worldwide Interest (Unadjusted)	800	800
Net Worldwide Interest (Adjusted)	600	600

Commentary

The net interest expense of the UK Group is the interest on Loans A and B: 400.

The net interest expense of the Worldwide Group is the interest on Loans A, C and D: 800.

In Year 1, the UK net interest:EBITDA ratio is 40 per cent. Ostensibly, therefore, 100 of interest expense will be denied under the fixed ratio rule on the basis that 30 per cent of UK EBITDA is 300.

Applying the group exception:

- the unadjusted worldwide net interest:EBITDA ratio would be 50 per cent and so UK net interest expenses could be claimed, under the group exception, at up to 50 per cent of 1000 and there would be no restriction on the 400 of actual UK interest expenses;
- the adjusted worldwide net interest:EBITDA ratio would be 37.5 per cent and so UK net interest expenses could be claimed, under the group exception, at up to 37.5 per cent of 1000 and there would be a small restriction (i.e. 25) on the 400 of actual UK interest expense.

In Year 2, the worldwide net interest:EBITDA ratio is 30 per cent (and 25 per cent on an adjusted basis) because the non-UK EBITDA is more significant. In this instance, the group exception would provide no relief from the fixed ratio rule.

The unadjusted interest expense figure reflects the qualifying worldwide interest expense if the interest on Loan D is not excluded under the related party proposals. The adjusted interest expense figure reflects the position if it is.

In Year 2, the worldwide net interest:EBITDA ratio is 30 per cent (and 25 per cent on an adjusted basis) because the non-UK EBITDA is more significant. In this instance, the group ratio rule would provide no relief from the fixed ratio rule.

Notes

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